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The Conference Board

The Impact Of Product Liability

Survey of 500 CEOs cites:

- *cancellations of acquisitions, research and products*
- *atmosphere of uncertainty for planning*
- *heavy demands on top executives' time*
- *significant expense*
- *another obstacle to U.S. competitiveness*

Research Report No. 908

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The Impact of Product Liability

by E. Patrick McGuire

A Research Report from The Conference Board

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From the President

During the summer and fall of 1986, The Conference Board conducted a survey among several hundred risk managers for *Fortune* 1000 companies. Many of these managers reported that their companies, while experiencing cost increases, were "adapting" to their problems with product liability, including the proliferation of lawsuits and the rise in insurance costs.[1] Critics of the report suggested that a broader look at the effect of product liability on overall company operations was desirable and that top management views should also be solicited.[2]

The Board therefore initiated a new survey among the chief executive officers of the 2,000 largest manufacturing companies as well as a randomly selected group of 2,000 manufacturers having less than 500 employees. The purpose of these surveys was to obtain the views of CEOs on how product liability was affecting their companies' present operations and their plans—including direct and indirect costs, foregone opportunities, and use of executive time. Chief executive officers were also asked to give their opinions of proposed and pending tort reform measures and to gauge the impact that the U.S. product liability system has on the ability of U.S. firms to compete with foreign producers.

This study, which reports the results of these surveys and a series of interviews, presents a full, detailed description of how a substantial number of the nation's top executives view the issue of product liability. The Conference Board hopes that this account of their views will be a valuable contribution to the ongoing debate on this complicated issue. We are grateful to the many executives who participated for sharing their views and experiences.

JAMES T. MILLS
President

[1] See Nathan Weber, *Product Liability: The Corporate Response*, Conference Board Research Report 893, 1987.

[2] See, for example, the evaluation of Victor Schwartz in "Product Liability: A Crisis Well With Us," *Across the Board*, Vol. XXIV, No. 10, October 1987, pp. 14-22.

Highlights

The rapid growth in product liability litigation, as well as the hazards associated with substantial jury awards, has had a significant impact on corporate America. It has affected not only today's operating costs—both direct costs as well as indirect and "transaction" costs—but also business plans for the future. Many of the more than 500 CEOs surveyed complain of operating in an atmosphere of uncertainty. They have already closed some operations and laid off employees engaged in making products considered to be potential liability risks. Equally important, they have cancelled plans for new products, backed off from promising acquisitions, or curtailed new product research because of uncertainties and fears related to product liability. All of this, the CEOs say, has made U.S. businesses less competitive in world markets.

Many of the executives are also concerned about the amount of time that product liability issues consume. It is not uncommon for a CEO to spend several weeks a year involved with product liability testimony, discussions, and the like.

Both small and large companies are adversely affected by product liability—but often for different reasons. In larger firms, liability considerations are more likely to appear as indirect costs, taxes on employees' time, and obstacles to new product development efforts. In smaller firms, the effects are felt more directly, often as the result of rises in insurance costs or difficulties encountered in obtaining adequate insurance coverage.

Nearly all of the executives surveyed would like to see serious reform of the nation's product liability laws. Some are encouraged by reforms that have occurred at the state level, but are pessimistic about the chance for reform at the federal level. Most of all, the executives advocate replacing the present strict liability system with one based on fault. They would also like to curtail or eliminate the current doctrine of joint and several liability. Ideally, they would like to see a cap placed on pain and suffering damages—and some states have already enacted such reforms.

Looking ahead, most of the CEOs expect the situation to continue to deteriorate and liability concerns to be an even more significant burden. But this pessimism is tempered among some who believe that the continued campaign for product liability reform will eventually be successful in creating a legal and business climate in which certainty is a more prominent feature.

About this Report

This report refers to several closely related issues with a single term: "the product liability system." First of all, it is impractical to separate issues such as product liability litigation, claims for damages that are not litigated, threats of litigation, the cost or availability of liability insurance, and similar related factors from one another. Secondly, senior executives, while recognizing that these are different topics, tend to identify them all as part of what they call "the product liability system."

This usage is not simply a matter of convenience: It reflects a common view of the general impact of product liability in business. Firms that are affected by the threat of litigation—whether or not they have been defendants in liability suits—see themselves as no less affected because they have thus far escaped formal legal proceedings. They make little distinction among litigation costs, costs for insurance against losses arising from litigation, and the internal transaction costs or lost opportunities that the product liability system may impose. The terms that senior executives use to describe the liability situation or issue also tend to be pejorative. Many respondents, for example, speak of the product liability "crisis" or "mess."

Some of the specific terms used in discussing product liability are defined in the box on page x.

The CEO's Viewpoint

As noted (see *From the President*), The Conference Board's previous study on product liability sought specific information on topics such as the number of suits companies faced and the cost of insurance. It did not address the extent to which business operations overall might be affected by the product liability system.

Obtaining such insights requires going to the most senior executive in the company. The chief executive officer is in a unique position to describe not only actions taken as a result of product liability considerations but also actions refrained from, such as the pursuit of new products or planned business acquisitions. Moreover, the chief executive officer, as the corporation's ultimate strategist, is best qualified to provide an opinion on how the product liability system may affect the firm's growth prospects and market opportunities. In addition, the Board has found that CEOs' views on such issues as the ability of business to be internationally competitive have proven remarkably prescient. The conclusions the executives draw have great value for those concerned with the ability of U.S. business to remain competitive in world markets.

This study is focused exclusively on product liability. Therefore, the study participants represent only those firms that might either manufacture various products or cause them to be manufactured and introduced into the stream of commerce. With the exception of some retailers, the respondents are nearly all producers of various consumer or industrial products.

Numerous other individuals and institutions are also affected by the tort liability system. A variety of personal and professional services are vulnerable to charges of malpractice, negligence and the like, which can generate liability litigation. The providers of such personal, professional and business services also require liability insurance and are affected by changes in its price and availability and by changes in the underlying liability system. But those sectors of the economy are outside the scope of this study, which focuses, as did the earlier Board study, on the product component of the liability system.

Study Methodology

This study is based on one survey mailed to two classes of manufacturers—the *Fortune* 2000 and a selected group of smaller firms—as well as on interviews and an analysis of significant secondary sources. In the overwhelming majority of instances chief executive officers responded personally to the surveys for this study. In a few instances CEOs chose to refer the questionnaire to other knowledgeable officers in the company, including the chief legal officer, the senior vice president of public affairs, or similar high-ranking executives. There is no reason to believe that these executives' views differ substantially from those of their firms' CEOs.

Survey questionnaires were sent to all 2,000 of the largest U.S. manufacturing companies, but respondents tended to be more concentrated among larger producers than smaller ones. A separate mailing of the survey to significantly smaller firms, members of the National Association of Manufacturers, also provided information for this study.

The mailing to the 2,000 largest manufacturing firms was

concluded in November, 1987, and provided 270 usable responses. A mailing to 1,200 manufacturers having sales of less than $100 million per year and to 60 major retailing firms—many of which own or control manufacturing facilities here and abroad—enriched this base. This survey was also sent directly to chief executive officers, whose names were derived from official records provided by state and federal Security and Exchange Commissions.

A separate mailing to 2,000 small manufacturers produced 280 responses. These firms were selected from the membership list of the National Association of Manufacturers (NAM) and the survey forms were mailed by NAM. From its 13,250 members companies, NAM selected 7,000 firms which had less than 500 employees—the U.S. Small Business Administration's definition of a small business. From this group, 2,000 firms were selected on a random basis to receive the questionnaire. The questionnaires were returned to NAM and the originals were forwarded to The Conference Board for analysis.

As Table 1 illustrates, a third of the *Fortune* 2000 companies responding have more than $1 billion dollars in sales. In this respect the respondent population fairly closely mirrors the characteristics of the *Fortune* 1000. As expected, most of the companies responding have a large number of employees. More than four out of ten companies report more than 5,000 employees; three out of ten report 10,000 or more (see Table 2).

About six out of ten companies studied produce industrial products; about 40 percent are consumer product firms. One-third of all the firms provide industrial raw material supplies and components rather than finished products (see Table 3).

In any study of a controversial issue, it can be expected that those firms most affected will have a greater tendency to respond to surveys about the issue. However, an analysis of returns to this survey finds many replies from firms reporting that product liability is not a major issue for them. Thus, these survey results do not seem to reflect only the views of firms most concerned about this subject.

The design of the survey questionnaire involved the review and suggestions of more than 60 interested parties. These included senior executives from The Conference Board's Public Affairs Research Council, the corporate counsel of various firms interested in and knowledgeable about product liability issues, executives from insurance firms, tort reform lobbyists, representatives of the plaintiffs' bar, and legal scholars expert in the topic.

Conference Board researchers also attempted to obtain material from key trade associations representing industries said to be particularly affected by product liability issues. Fifteen

Common Terms in the Liability Arena

Captive Insurer: A liability insurer specifically established to serve the needs of a limited group of firms with allied risk potential, a profession with similar risks, and the like. This firm does not offer insurance to "outsiders," those outside a designated industry or profession. Frequently, the captive insurer firm is founded by an association or consortium of firms or individuals.

Catastrophic Coverage: Special insurance coverage provided as an addendum or separate policy to cover worst-case losses—oil spills, multiple injury losses, and the like.

Collateral Source Payments: Payments made to the plaintiff by insurers, employers or others for damages suffered which are not allowed to be considered—or deducted--from the total of damages paid by defendants in tort actions.

Comparative Negligence: A principle in which the degree to which a plaintiff contributed to a tort is considered in deciding the extent to which the manufacturer will be held liable for the plaintiff's injuries. The principle embodies the concept of a proportionate sharing between plaintiff and defendant of the negligence.

Federal Preemption: A principle by which federal law in many cases takes precedence over state law. Enactment of a federal safety statute, product liability law, or the like, would establish a national standard and obviate—and usually make invalid unless explicitly exempted—state laws dealing with the same topic.

Going Bare: Operating without either insurance or any reserves set aside to pay for claims made against the company.

Joint and Several Liability: A principle whereby multiple defendants named in a injury suit will all be held responsible for the tort committed and whereby the wealthiest defendant may often end up paying a major—or the total—portion of the damages regardless of the extent of responsibility for the tort. In such actions all defendants may be sued together or any one defendant may be sued to recover the full damages.

Self-Insurance: A self-insured company establishes its own reserves to pay liability claims, handles its own claims against the firm, and makes payment from these reserves. At times it also carries a separate policy to cover "catastrophic losses."

State-of-the-Art Defense: A defense pleaded by a manufacturer defendant in which it is asserted that the producer used all technology and care known at the time of manufacture to make a safe product.

Strict Liability: A broad principle of product liability law which holds that a manufacturer is responsible for the torts (wrongful acts for which suits may be brought) that its product produces, regardless of whether the product was made properly when entered into the stream of commerce. In other words, this principle establishes liability without the showing of fault.

trade associations were selected, based on testimony they had offered before various state and federal legislative committees citing the impact of product liability on their associations' member companies.

However, when The Conference Board contacted these associations for specific evidence, such as member surveys and research reports, it was determined that the bulk of the evidence was anecdotal in character. While some surveys detail the run-up in insurance cost in particular industry associations, little—if any—data provide a composite view on the number of suits filed against association members, economic losses sustained as a result of product liability, or various adverse impacts that members might have reported. While trade associations have vigorously advocated tort reform, they have not systematically gathered empirical evidence from member companies on the impact that the tort liability system has had on them.

The data and views contained in this report are derived solely from the research study as described above. The report represents, to the degree possible, the consensus views of the respondents. It does not represent the position of The Conference Board, which is precluded by its charter and status as a Section 501-C-3 organization from taking positions on any of the issues discussed in this report. Rather, this study represents The Conference Board's best effort to present accurately the views and comments of the executives who participated.

Table 1: Sales Annual of *Fortune* 2000 Companies Responding

Annual Sales $	*Percent Distribution*
Less than $50 million	6
$50-99 million	7
$100-199 million	18
$200-499 million	19
$500-999 million	17
$1-5 billion	24
More than $5 billion	9
	100%

Based on responses from 243 companies.

Table 2: Employment Size of Companies Responding

Number of Employees	*Percent Distribution*
Less than 500	11
500-999	11
1,000-4,999	35
5,000-9,999	14
10,000-19,999	11
More than 20,000	18
	100%

Based on responses from 248 companies.

Table 3: Principal Product Lines of Companies Responding

Product Categories	*Percent Distribution*
Consumer Durables	12
Consumer Nondurables	29
Industrial Equipment & Machinery	26
Industrial Supplies & Materials	33
	100%

Based on responses from 264 companies.

Chapter 1

Assessing the Overall Impact

The Conference Board surveys sought to determine CEOs' views on the overall impact of the product liability system on their firms and their industries, as well as on their costs and operations. (See box on p. 2 for a profile of the affected firms.) Looking at the impact on their individual firms, four out of ten CEOs believe that the system has had a major impact on their companies—affecting how they plan and do business in addition to imposing costs and penalties unique to the U.S. business environment. Only 20 percent of the companies studied say that the product liability system has had a minimal impact on their particular companies (see Table 4).

The size distribution of the companies studied is quite broad, as illustrated in Table 1. The product liability system seems to impose the heaviest burdens on firms with less than $100 million in sales and on those with more than $5 billion in sales (Table 5). For firms at the lower end of the size spectrum (less than $100 million in sales), most of the problems result from escalation in the cost of insurance premiums and legal transaction costs. Larger firms are less likely to be affected by insurance costs—since some are essentially self-insured—and more likely to be affected by transaction costs and the displacement of a key executive personnel from managerial functions to litigation-related duties.

Although the burden they report is not as great as that of industrial capital goods firms, consumer durable producers—manufacturers of autos, small and large appliances, and the like—are likely to be adversely affected by the system, with just over half reporting a major impact. These kinds of firms are followed closely by industrial equipment and machinery companies, also with just over half reporting that the system has a major impact (see Table 6).

Many CEOs also believe that the product liability system has had a major effect on their industries as a whole (see Table 7). In general, CEOs consider that the system has had a slightly more onerous impact on their industry as a whole than on their own firms, regardless of the size or product type of the firm (see Tables 8 and 9).

An Atmosphere of Uncertainty

One of the most pernicious effects of the product liability system, the CEOs say, is its impact on business planning and decision making. "We can live with nearly any system," one executive said, "as long as there are some standard rules or guidelines. We may not like the system, but at least we can plan for it." But this is not the case, a majority of CEOs believe, in the present situation. The chairman of one multinational company describes product liability as a "lottery with no consistency in the size of awards [granted to successful plaintiffs]."

Given the nature of the U.S. jury system, there is simply no way to predict what is likely to happen, some CEOs feel. A tool company president, for example, says, "the likelihood of a runaway jury verdict, along with judges' discretion in imposing sanctions, prompts settlements at levels which are out of all proportion to the contribution a manufacturer makes to a plaintiff's injuries."

The president of an aerospace products firm summarizes the inherent difficulties that the product liability system creates for business planning:

> The primary impact results from uncertainty, which makes rational business planning impossible. We're defending suits involving ancient products, with claims that were totally unforeseen when the products were designed and sold and when insurance was purchased. It is impossible to predict what future application of product liability law will be made to today's products. . . .We can take no adequate precautions against future liability.

For individual companies the uncertainty of the system can precipitate a crisis. The chief executive of one of the nation's largest pharmaceutical companies points out:

> The impact of the product liability system on our company is now at a turning point. Both the number of cases filed and the cost to dispose of each case are increasing at an accelerated pace. In the past six years more product suits have been filed against our company than in its previous 105 years of existence. We must now pay substantial sums to settle suits that a few years ago would have been settled only for nuisance value or not at all. The unpredictability of the system is exacerbated by the disappearance of liability insurance. Like others in our industry, during the past two years we have seen our company's product liability insurance shrink to such an extent that for future losses we now carry only catastrophic coverage—and we obtained that limited coverage only by forming a group

captive insurer along with other manufacturers unable to obtain traditional coverage.

Insurers are even more distressed by the unpredictable nature of product and environmental liability. The senior vice president of the Alliance of American Insurers sums up his industry's view, stating:

> If insurance is to work, insurers must be able to predict how frequently insured events will take place, and how large a loss those events are likely to cause. Predictability in these elements is essential for insurers to price their coverage and to know the extent of the liability they are assuming under the insurance contract.[1]

Vanishing Firms and Industries?

At its most extreme, product liability can be fatal to the health of the firm. One aerospace supplier, with several major divisions facing liability problems, pointed out that the "impact on our firm's profitability was a major factor in putting the company 'into play.' This resulted in an investment banking group acquiring and breaking up the corporation."

The president of a major sporting goods company points out that the entire recreation sector could be affected by product liability:

> All recreation activities now conducted in an organized format will likely be discontinued as parks, schools, camps, Boy Scouts, etc., are unable to obtain insurance. Not only our company, but an entire industry could well be eliminated. It may be too late now! The overhang in pending litigation could sink many companies in the sporting goods industry.

In some industries, experts say, the liability "overhang"—the tort liability for products manufactured in the past—is severe enough to give foreign producers a significant advantage over U.S. companies.[2] For example, aircraft producers are liable for airplanes produced many decades ago. Cessna Aircraft recently settled a suit for a plane manufactured in 1953.

The insurance premiums aircraft producers currently pay, and the reserves they must set aside, reflect the present "overhang" in the product liability climate. The total accident rate in 1985 fell to 8.5 accidents per 100,000 flight hours compared with 20.5 in 1968. But product liability awards rose from $46.6 million in 1982 to $210 million in 1986. And the number of claims—some of which will result in awards—has also increased precipitously. Beech Aircraft faced a total of $447 million in claims in 1984, but by 1986 the value of claims had risen to $1.1 billion.

[1]See Clark Embler, "Pollution and Liability," *The Corporate Board*, May/June 1987, p.13.

[2]Besharov, Douglas, *The Lesson of Bhopal: International Trade Consequences of American Tort Liability*, Washington Legal Foundation, Washington, D.C., 1987.

Defining the Degree of Impact

For this study, chief executive officers were asked to describe whether the product liability system had a *major, moderate or minimal* impact on their firms. These terms are not, of course, quantitative. It is possible that two different executives—whose firms experienced essentially the same degree of economic impact—might differ as to whether this impact was "moderate" or "major." These differences in perception could reflect a variety of factors—for instance, publicity associated with the drive for tort reform, personal experiences with claims or litigation, and the costs or burdens encountered as a result of product liability suits.

However, additional data help confirm the executives' perceptions. The Board's questionnaire reveals the extent to which the firms experienced specific adverse consequences, such as plant closings or layoffs. Survey data also indicate whether the firms anticipate such impacts as a result of the product liability system. Thus, it is possible to construct a profile, albeit imprecise, of firms in each of the three categories of impacts. These can be summarized as follows:

Major Impact: Firms in this category have seen significant increases in direct costs—usually in excess of 15 percent in the past three years—as well as general and administrative cost increments in excess of 10 percent. Usually they have also experienced and/or anticipate five out of eight of the following adverse effects (as shown in Table 27, page 16): (1) closure of plants; (2) discontinuance of an existing product or products; (3) layoff of employees; (4) loss of market share; (5) discontinuation of research on liability-prone product lines; (6) movement of production to overseas location; (7) loss of market share; (8) decisions not to introduce newly developed products.

Moderate Impact: These firms have experienced some increments in direct as well as general or administrative costs and at least four of the consequences listed above—most often from anticipated rather than actual experience.

Minimal Impact: These companies had no significant (no more than 2 percent) increases in direct costs and no direct experience with the eight adverse consequences or preventative actions listed above.

The CEO of another small aircraft manufacturer states that "the current product liability system has essentially destroyed the piston aircraft industry. From a peak of 18,000 aircraft per year in 1978-79, the total current piston aircraft production in this country has fallen to less than 1,000 units per year."

Product Liability and Executive Time

Among the reasons that chief executives are adamantly opposed to the current product liability system is the enormous tax it exacts on executives' time. Senior executives are

Contradictions in Public Opinion

Research in the field of product liability often finds the public ambivalent about the system itself and its consequences. For example, in late August, 1987, Media General and the Associated Press polled a representative group of 1,223 adults, asking them whether they thought that plaintiffs filing liability cases against companies, towns, doctors or similar defendants were receiving damage awards adequate to their losses. Fifty-one percent thought that the damage awards were excessive; eight percent thought they were "not enough." When asked who was probably most responsible for excessive awards, respondents cited plaintiffs' lawyers as the culprits most often, with 63 percent believing that such attorneys were "very responsible" for this situation.

At the same time, however, it would appear that a majority of those polled are not in favor of altering radically the way that the product liability system works. For example, 54 percent of the respondents believe there should not be a cap on the amount of money that can be awarded in an injury case, and a majority of the respondents think that a jury should set the award amounts. And nearly eight out of ten believe that individuals should be allowed to sue government agencies for damages.

This same ambivalence often marks the debates surrounding tort reform legislation at the state level. Many state legislators believe there are abuses in the product liability system, but they are resistant to tampering with how the system itself works by, for example, restricting the right to jury trials or setting caps on damages.

often called on to testify—both in depositions and in court—on products their companies have manufactured. Although companies win a majority of cases, the process of defense nonetheless absorbs significant amounts of executives' time. For example, a number of years ago Dow Chemical bought the pharmaceutical division of Richardson Merrell Company and created a subsidiary, Merrell-Dow Pharmaceuticals. Merrell produced a drug, Bendectin, which was given to 33 million women throughout the world. A number of lawsuits alleged that Bendectin was responsible for birth defects. The company has been sued numerous times, but has won every case except four, all of which are being appealed.

Once the suits began, company officials took a hard look at the cost of litigation compared with product revenues. At one point the company was selling $20 million a year of the product, but spending $18 million just for legal and insurance costs. Not surprisingly, the company discontinued the product. More than 12,000 doctors in the United States officially protested the product's cutoff, saying that it was a useful drug.

In the meantime, Dow's senior management was repeatedly asked to testify in various product liability cases involving Bendectin as well as other Dow products. The company's chief executive officer, in a recent statement, described how this affected his work life:

> Our management, including myself, spends an enormous amount of time being deposed and appearing in court. I wasted more than twenty working days in 1986 alone on legal cases. In February, 1987, I was deposed as a witness in a case against some other company. Dow Chemical was merely a customer of theirs, and the plaintiff's lawyers calculated that I wouldn't bother to show up. This was part of their strategy to win a settlement. But I fooled them; I did appear. But it meant hours of depositions, following hours of time spent in preparation. I lost one full working day in order to make a deposition that didn't even involve a suit against Dow Chemical but against a company that merely sold us a product.[3]

Impact on International Competitiveness

Comparing Costs

Half of the CEOs responding to the survey believe that the product liability system is having a major impact on the ability of U.S. firms to remain competitive in world markets. Only 14 percent believe the system has a minimal impact (see Tables 10 and 11). The present system is anti-competitive, these executives say, because of the added costs it imposes on U.S. producers, the legal risks to which it exposes domestic producers, and the resources—both financial and human—that it absorbs.

Stung by what they regard as an "uneven playing field"—including competitive advantages due to government subsidies of foreign competitors, nontariff trade barriers, and the like, the senior executives see product liability as one more area in which foreign producers gain an unfair marketplace advantage. The chairman of the Business Roundtable's Tort Policy Task Force summarizes this view:

> Ultimately it is American consumers and American workers who bear the burden of our irrational tort system. Consumers pay the bill for tort litigation through higher prices, and also through reduced availability of goods and services. American workers share this burden, as jobs are lost to foreign competitors that face lower costs and fewer barriers to new product introductions.[4]

In many of the comments offered on this point there is a flavor of impatience and anger. The chairman of one company, with more than 25,000 employees in the United States, says:

> This [the product liability system] is an extremely serious problem in the context of U.S. competitiveness. It needs urgent attention. The present system has become totally corrupt: a severe and unpredictable cost for business and a totally in-

[3]Paul F. Oreffice, "The Year Tort Reform Must Happen," *Imprimis*, Hillsdale College Center for Constructive Alternatives and the Shavano Institute for National Leadership, Volume 16, Number 7, July 1987.

[4]Testimony of Robert H. Malott, CEO, FMC Corporation, before the Sub-Committee on Commerce, Consumer Protection and Competitiveness of the Committee on Energy and Commerce, U.S. House of Representatives, May 5, 1987.

equitable and randomly variable benefit for victims. It provides money for unscrupulous lawyers and is a serious economic and social distortion.

The chairman of the board of Mack Trucks Inc. told a Congressional committee that "product prices have increased, products have been discontinued, innovation has slowed, plants have closed, and thousands of American workers have lost their jobs." He went on to explain that even though his company has not had significant judgments against it, the firm's insurance writers declined to renew the company's liability insurance in 1986 and, as a result, the company is now self-insured.[5]

Product liability insurance costs are substantially lower in foreign jurisdictions. A 1984 study commissioned by the U.S. Department of Commerce found that foreign competitors often have product liability insurance costs that are 20 to 50 times lower than their U.S.-based competitors. Following the run-up in product liability insurance costs during 1985 and 1986, this competitive advantage may have increased even further.

Part of the concern with international competitiveness relates to direct expenses for insurance premiums and legal fees. Dow Chemical has approximately $13 billion in annual sales, $7 billion derived from foreign sales and $6 billion from domestic sales. In 1986 the company's legal and insurance expenses in the United States totaled more than $100 million. Overseas, less than $20 million was spent for comparable coverage even though more than half the company's sales were achieved in those markets. During 1987, Dow was the defendant in the United States in 456 suits. Only four suits were filed against the company outside the United States in that year.

Indirect costs are cited as well. The chief executive of a consumer appliance company believes that:

> U.S. manufacturers are under severe competitive handicaps as compared with foreign manufacturers, whose products are generally handled by small U.S. importers. Foreign manufacturers and importers may not have the resources to deal with product liability problems, or share the same sense of concern, and therefore may not seek the protection that a U.S. manufacturer would obtain. An injured U.S. consumer may well be unable to obtain redress because the importer or foreign manufacturer may not be accessible. Consequently, the effort and expense by the foreign manufacturer, in terms of development in safety of the product, may be little compared with that of the U.S. manufacturer.

Many of the executives are disturbed by the idea that their foreign competitors can devote all of their energies to producing and marketing products, while they cannot. A machinery company executive points out that his company has "directed very substantial hours of creative and technical time away from running the business to defending the business from unwarranted attack. It is very difficult to remain competitive in world markets when so much cost and time is spent defending the company rather than reducing cost and serving customers."

Another machinery producer compares the impact of product liability with various regulatory structures, and sees this system as one more impediment to international competition. "As with other regulations," he observes, "we will soon find ourselves priced out of the world market because of the [increment] in cost."

Comparing Legal Systems

While many executives make note of the high product liability costs in the United States, some also point to the other side of the coin—a less burdensome legal system in other countries. The president of a major electronic systems company, with over 5,000 U.S. employees, comments:

> The product liability system, including the level of potential recovery, is highly exercised in the United States compared with the equivalent recourse elsewhere in the world. If awards continue unabated, a corresponding reduction of equitable competition in world markets must follow. Individual situations benefit [but] at the expense of the balance of the [U.S.] population.

The chief executive of one northeastern manufacturer states, "Some foreign countries have severe limits on liability exposure. These countries accept the theory that when one uses a power tool, there is an inherent danger to one's person, and when one straps two sticks of wood on one's feet and heads down a snow-covered hillside, one accepts responsibility for the danger involved."

Foreign producers have an advantage over U.S. companies, many respondents say, because injured American consumers often have difficulties in serving legal papers on foreign corporate defendants, while non-U.S. citizens have easier access

State-by-State Impact

There is little doubt that the effects of the product liability system vary from state to state. The interpretations of local or state courts, the climate for litigation, the number of plaintiffs' attorneys, and a host of other variables can affect exposure in a particular state. The effect of significant precedent cases is especially powerful. For example, a paper company in the State of Maine reports that it has had particular difficulties operating there. The company president says, "At our Maine mill we have to go to self-insurance. The insurance companies can't cover the cost and some companies have abandoned business there. Our costs have risen well over 300 percent."

While it is difficult to know with any certainty, it appears from the comments of this firm and others that managements have decided that certain states, because of liability considerations, are not hospitable environments for new investments. This view, in turn, may dampen economic development in these states.

[5]See Nathan Weber, *Product Liability: The Corporate Response*, Conference Board Research Report 893, 1987, which illustrates that companies usually win two-thirds of the cases that go to court.

to U.S. courts. A recent bill, introduced by U.S. Representative Daniel R. Glickman, Democrat of Kansas, would give U.S. courts the same kind of jurisdiction over foreign companies that make and sell products in the United States as the foreign courts currently have over American-based firms.

In comparing U.S. and foreign legal systems, a natural resources company official points out, for example, that although Russian and South African asbestos producers have been major sellers of asbestos fibers in the U.S. market for a number of years, none of these firms has contributed in any meaningful way to payments to U.S. claimants who suffered asbestosis as the result of exposure to this product.

In another case, a chemical company's general counsel related an incident in which a German citizen sued a firm in the United States from which he had purchased an allegedly defective heart valve. The product was purchased in Germany and installed by German surgeons. Nonetheless, the counsel points out, the U.S. company had to spend substantial amounts of time trying to prevent U.S. courts from accepting jurisdiction of the case.

Ironically, even the U.S. subsidiaries of foreign-owned companies complain about particular problems with the U.S. product liability system. One auto company executive, for example, explained that his parent company, a European firm, did not always appreciate the complexity and cost associated with the U.S. product liability system. He pointed out that his subsidiary was attempting to get the parent to absorb the U.S.-based costs of product liability, but thus far had not been successful. This executive also noted that although the firm had not had any major product liability losses, it was well aware that "only two or three [adverse] cases could wipe out the entire profits of the firm's U.S. subsidiaries."

The question of whether foreign plaintiffs gain an advantage by suing in U.S. courts is clouded by policy and procedural guidelines. The U.S. Supreme Court has given the federal district courts considerable discretion in deciding whether to assert jurisdiction in liability cases brought by foreigners against U.S. firms. In general, the doctrine of *forum non conveniens* holds that the case should be tried in a jurisdiction convenient to the claimants, the witnesses to the alleged tort, and to the documents relevant to the cases. And, in most cases, U.S. courts have interpreted the doctrine so as to reject foreigners' attempts to gain access to the U.S. courts—and to our liability system.

The *forum non conveniens* doctrine is not, however, an impenetrable barrier. Sometimes U.S. courts do accept jurisdictions, which can give foreign claimants a substantial advantage in obtaining a contingency fee attorney, in the rules of discovery, and most importantly, in the size of the award. Recently, a California appellate court encouraged foreign plaintiffs to use that State's courts in liability actions.[6]

[6]See *Corrigan v. Shiley, rev. denied* Cal. Supreme Court (1986), *cert. denied sub nom.*, U.S. Supreme Court (1986).

Asbestosis and Lead Paint Poisoning

A flood of product liability suits lodged against makers of asbestos products has cost manufacturers millions of dollars in damages and resulted in the bankruptcy of the Johns-Manville Corporation. In those cases the plaintiffs' lawyers were able to prove to the satisfaction of the courts that the defendants had knowledge of the carcinogenic effects of asbestos fibers—and took precautions to protect some of their own workers—but failed to warn installers and users of hazards associated with the product. There are literally thousands of building sites from which asbestos building products are now being removed in order to reduce the hazards of inhalation of asbestos-containing dust and hence possible development of asbestosis in occupants. There are numerous other instances in which the "liability overhang" that confronts an industry places a significant burden on firms' planning efforts. The following is one example of such situations.

A group of plaintiffs' attorneys is attempting to prove that the makers of lead-based paints are similarly liable for deaths or disabilities suffered by children. Attracted by the sweet taste of the paint, some children chew or ingest such paint from woodwork and other building surfaces long ago coated with lead-containing paints. Four Massachusetts law firms recently filed suits in the U.S. District Court in Boston, the Suffolk County Superior Court in that city, and the Hampden County Housing Court in Springfield, Massachusetts. They named as defendants five lead and paint company producers, along with their trade association, the Lead Industries Association.

It could take years for these cases to wend their way through the courts. In the meantime, a cloud of uncertainty may hang over some companies because of the economic impact that an adverse trial result could have. The American Academy of Pediatrics estimates that between 1976 and 1980 over 780,000 pre-school children had excess levels of lead in their blood. Medical specialists believe that an untold number of children have been irreversibly affected by lead poisoning, but no one has any precise statistics on such impacts.

This should not be taken to suggest that the lead industry, paint manufacturers, and producers of asbestos are in comparable situations. Paint manufacturers voluntarily reduced the lead content in paints (to the American Standards Association level of 1 percent) in 1955. All lead paint was subsequently banned in 1977. Nor has the industry maintained a double standard of safety, with one level of safety for workers in its plants and another for installers of its product (as was shown in the asbestos cases).

Still, no one knows how the lead paint cases will be resolved. Undoubtedly additional suits with multiple defendants will be filed. Through the mid-1970s there were nearly a thousand establishments manufacturing paint or coating products, a majority of which could have contained lead additives or pigments. Thus, the number of potential defendants is as broad as any plaintiff attorney's imagination.

CEOs Assess the Future

Two-thirds of all the CEOs surveyed say that the product liability system is likely to have an even more significant impact on their companies in the near future (see Table 12). Only two percent of those surveyed believe that the issue will recede in importance. One executive, for example, says his company has thus far "dodged the bullet" on a major product liability claim. However, the executive points out that other companies in his industry have not been so fortunate and that, in his view, "it is only a matter of time before it is our turn." Beyond analyzing the specifics of tort reform (as described in Chapter 4), some executives commented on what the current product liability system implies for the future.

Taking a broader look at the system, the president of an electronic instrument firm declares:

> It is not clear at this time that our product liability system has correctly balanced safety incentives, risks and rewards for the innovators, relief for the innocently injured, and justice for all. A complete overhaul of the system probably is not necessary. Changes are needed to increase consistency in the law from state to state and to reduce the potential for damage awards that are entirely disproportionate to the degree of culpability of the defendants.

At the same time, some CEOs are increasingly cynical about the chances for reform at either state or federal level. In part, they blame this on the legal profession. "Lawyers benefit from the present system," one electrical company's CEO explains, "and 70 percent of the members of Congress are lawyers looking forward to hanging out their shingles. The chances of changing the laws that benefit lawyers so much are remote."

Echoing this sentiment, the president of one diversified manufacturing firm, with 5,000 U.S. employees, says, "Congress is controlled by lawyers and lawyers are getting rich quick on product liability cases. No action is likely to occur except to try to shift the blame onto the insurance industry."

The CEO of a packaging company is concerned about what the product liability system says about American society at large:

> Our society appears to be adopting a philosophy that puts no responsibilities on individuals for their own conduct. In the face of this, even the most extreme efforts to design products with safety in mind, and to promote their safe use, appear doomed to failure since either the American jury system will award large damage claims to plaintiffs based purely on emotion, or product liability insurers will agree to settlements out of fear of subjecting an otherwise winnable case to such a jury.

A majority of executives, three-quarters, believe that the United States will be increasingly disadvantaged in world markets unless modifications are made in the liability system (Table 13). Despite recent changes in product liability law and regulation in the European Economic Community, few of the executives questioned believe that foreign producers will face a product liability climate resembling that of the United States. Only four percent of those surveyed expect this issue to have a declining significance on U.S. international competitiveness.

Table 4: Impact of Product Liability System on Individual Firms

Degree of Impact Reported	*Percent Distribution*
Major	42
Moderate	38
Minimal	20
	100%

Based on responses from 263 companies.

Table 5:
Impact of Product Liability on Individual Firms
by Size of Firm (annual sales)

Degree of Impact Reported	Percent Distribution						
	Less than $50 million	$50-99 mil.	$100-199 mil.	$200-499 mil.	$500-999 mil.	$1-5 billion	More than $5 bil.
Major	53%	56%	44%	30%	43%	35%	54%
Moderate	27	22	38	49	35	42	30
Mirninal	20	22	18	21	22	23	16
	100%	100%	100%	100%	100%	100%	100%

Based on responses from 242 companies.

Table 6:
Impact of Product Liability on Individual Firms
by Product Type

Degree of Impact Reported	*Percent Distribution*			
	Consumer Durables	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Major	52%	34%	53%	40%
Moderate	42	34	26	47
Minimal	6	32	21	13
	100%	100%	100%	100%

Based on responses from 261 companies.

Table 7: Impact of Product Liability on Industries

Degree of Impact Reported	*Percent Distribution*
Major	45
Moderate	39
Minimal	16
	100%

Based on responses from 261 companies.

Table 8: Impact of Product Liability on Industries
by Size of Firm (annual sales)

Degree of Impact Reported	Percent Distribution						
	Less than $50 million	$50-99 mil.	$100-199 mil.	$200-499 mil.	$500-999 mil.	$1-5 billion	More than $5 bil.
Major	58%	33%	44%	38%	51%	40%	57%
Moderate	28	50	37	51	28	39	33
Minimal	14	17	19	11	21	21	10
	100%	100%	100%	100%	100%	100	100%

Based on responses from 240 companies.

Table 9: Impact of Product Liability on Industries by Product Type

	Percent Distribution			
Degree of Impact Reported	*Consumer Durables*	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Major	61%	38%	54%	39%
Moderate	32	38	26	51
Minimal	7	24	20	10
	100%	100%	100%	100%

Based on responses from 261 companies.

Table 10: Impact of Product Liability on International Competitiveness

Degree of Impact Reported	*Percent Distribution*
Major	49
Moderate	37
Minimal	14
	100%

Based on responses from 260 companies.

Table 11: Impact of Product Liability on Competitiveness by Product Type

	Percent Distribution			
Degree of Impact Reported	*Consumer Durables*	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Major	48%	41%	54%	54%
Moderate	32	46	33	33
Minimal	20	13	13	13
	100%	100%	100%	100%

Based on responses from 260 companies.

Table 12: Expectations of Future Impact of Liability System on Firm

Impact on Firm	*Percent Distribution*
Will grow in significance	67
Will remain the same	31
Will decrease in significance	2
	100%

Based on responses from 261 companies.

Table 13: Expectations of Future Impact of Liability System on U.S. Competitiveness

Impact on U.S. Competitiveness	*Percent Distribution*
Will grow in significance	75
Will remain the same	21
Will decrease in significance	4
	100%

Based on responses from 258 companies.

Chapter 2

The Impact on Costs

Direct Costs

For nearly all of the companies studied, the product liability system has led to some increases in both direct and indirect costs. Four out of ten companies say that the product liability system has had a major impact on their direct costs (see Table 14). By definition, these are costs directly tied to products and companies' liability exposure for their products. Thus, costs for product-related litigation, the payment of claims or awards, and product-specific insurance are direct costs.

The direct-cost impact falls most heavily on the industrial equipment and machinery sector, as shown in Table 15. Consumer nondurables producers report the least impact on direct costs. Overall, the smaller companies among the *Fortune* 2000 tend to experience the most impact on direct costs. In total, as shown in Table 16, over a quarter of the companies surveyed report direct cost increases of more than 20 percent from 1984 to 1987.

Beyond direct costs, companies pay a lesser but significant toll in general and in administrative expenses (see Table 17). These are costs associated with staff time necessary to comply with certain liability-related tasks (e.g., responding to interrogatories and to discovery, increases in legal, professional and support staff, record-keeping and similar costs). A little more than a third of the companies surveyed say that the liability system has had a major impact on such costs. But the majority of firms report only moderate to minimal costs in this category. Many consumer nondurables companies have had significant increases in general and administrative costs, as have industrial producers, during the past three years.

As with direct costs, general and administrative costs from product liability tend to be highest among the smaller *Fortune* 2000 companies. More than half the companies with less than $50 million in sales, for example, report a major impact. In contrast, 30 percent of those with more than $5 billion in sales report such an effect (see Table 18).

The data also show that during the period 1984-1987 the increase in direct costs was significantly higher than in general or administrative costs. This pattern holds for both median and for average (or mean) cost increases (see Tables 16-25). By industry category, mean increases in direct costs for the period 1984-87 were again highest in industrial equipment (Table 19). Four out of ten companies in this sector report increases over 20 percent during these three years.

Smaller firms once again experienced the largest increase in mean direct costs (Table 20). Nearly two-thirds of these companies (with less than $50 million in annual sales), report a run-up of more than 20 percent in direct costs during the past three years. But the larger companies have not fared much better, with four out of ten experiencing a 20 percent or greater increase.

Indirect and Transaction Costs

Many of the executives interviewed, in particular corporate counsel, point out that what they call "transaction costs" of product liability claims and litigation are among the most onerous burdens that the system imposes (see p. 2, *Product Liability and Executive Time*). For example, an executive in a pharmaceutical firm asserts:

> The amount and the scope of litigation that the product liability system permits has put an increased burden on company employees, who must add to the responsibilities of their positions participation in product liability lawsuits. It is not uncommon for thousands of documents to be produced and eight to ten witnesses to be deposed in one lawsuit. The production of tens of thousands of documents and dozens of witnesses is less common but by no means rare. This involvement of nonlegal personnel is a major "hidden" but real cost of the product liability system.

The amount of staff time dedicated to providing litigation support—a key indirect cost—can, of course, vary widely among companies. There seems little doubt, however, that in some instances a great deal of valuable, productive time is lost. For example, a Mack Trucks Inc. engineer spent 116 hours on litigation support in a single month, according to testimony the company's chief executive officer presented before the House Education & Labor Subcommittee on Commerce, Consumer Protection and Competitiveness. The company

CEO said, "That time would have been much more productively spent the way Japanese engineers spend their time—developing new and better products."[1]

Problems in Measuring Costs

While 95 percent of the responding companies provided cost data, a number of firms noted that their data were based on "best estimates." A majority of those interviewed believe that their firms tend to underestimate the indirect and transaction costs associated with product liability, and several said that their record-keeping systems fail to capture such data. Very few companies have record-keeping systems that allow calculation of such costs on a per-share basis. One firm, Allied Signal Corporation, does have this kind of data and reports that product liability is costing its shareholders 36 cents per share each year.

The chief executive of one chemical company maintains that cost measurement may even be impeded because some firms are reluctant—"since this may open a floodgate of suits"—to conduct internal inquiries into the actual transaction costs in defending various cases. That is, by providing evidence of what a defense trial actually costs the companies may inadvertently supply documentation for plaintiff's counsel to use in seeking out-of-court settlements. The public affairs director for one consumer products company says that firms often find themselves in a situation where settlement cost may be increasing at only a relatively modest pace while the cost for legal defense may be skyrocketing. Thus, he claims, it is simplistic to look simply at claims or settlement payouts in estimating costs. It may not even be fruitful to consider only the cases filed in either state or federal courts. Often, there is significant negotiation—and negotiation costs incurred—between plaintiffs' attorneys and defense counsel before a suit is filed.

Dealing with Cost Increases

To deal with these cost increases, firms use three primary strategies: (1) absorb the cost, thus reducing their gross profit margins; (2) pass the costs on entirely in higher product prices; or (3) choose a mix of cost absorption and price hikes. Nearly half of the companies studied absorbed the cost of product liability and did not raise prices. But 12 percent did pass the cost directly on to consumers. A fifth absorbed part of the cost but passed the remainder on to product purchasers (see Table 26). Some cost increments passed on to purchasers were quite substantial. For instance:

- Lederele Laboratories increased the cost of its vaccine for diphtheria, pertussis and tetanus (DPT) from $2.80 per dose in June, 1986, to $11.40 a year later. Rising insurance costs and the expense of defending approximately 150 liability suits pending against the pharmaceutical producer were said to be primarily responsible for the price increase.
- Piper Aircraft estimates that insurance costs add $75,000 to the cost of every new plane built. Their product liability costs are said to be higher than their total cost of manufacturing some small aircraft. As a result Piper and firms such as Beech Aircraft and Cessna Aircraft have had to abandon some product lines and shut plants.

Improving the System

According to the president of one of the major U.S. oil companies:

> Business will continue to bear a twofold cost in product liability litigation. In the first instance the number and size of damage awards will increase. Secondly, the legal fees and related costs (so-called transaction costs) will continue to present an escalating expense regardless of the outcome of litigation. In order to minimize this threat, a new strategy is needed. Such strategy should include the funding of defense oriented groups, free exchange of defense information and the employment of a single law firm or counsel by multiple defendants to minimize individual cost.

As a goal, some executives would like to see a higher percentage of cases being brought to trial—but with an overall reduction in the number of cases. They reason that prompter, fairer settlements for deserving plaintiffs would result in lower legal transaction costs, for both plaintiffs and defendants, and that such reductions could prove sizable. But they are not sanguine about the current system providing for such settlements (see Chapter 4, *Reforming the Product Liability Tort System*).

Insurance: Cost and Availability

Virtually all companies surveyed report increases in insurance costs. But a number also face availability problems: Their insurance has been cancelled and they cannot get a new policy. Other companies have been faced with such drastic increments in cost that they could not afford to buy insurance and also stay in business. Fifteen percent of the companies chose to "go bare"—to operate without product liability insurance (see Table 27). Another 15 percent created their own insurance firms, or joined with other industrial members to form insurance consortia and thus obtain coverage through these "captive" insurers.

Seven out of ten companies report that they stayed with the same insurer but carried reduced amounts of insurance coverage or the same coverage at significantly increased cost. Survey respondents provided ample testimony to the extent of insurance cost increments. Among the comments are:

- A manufacturer of solid-waste handling equipment reports that during the past three years the cost of liability insurance has jumped from just over 0.1 percent to 1.8 percent of U.S. sales.

[1]Testimony of John B. Curcio, CEO of Mack Trucks Inc., delivered to House Education and Labor Subcommittee on Commerce, Consumer Protection and Competitiveness, May 5, 1987.

Pragmatism vs. Legalized Extortion

One of the most troubling aspects of the product liability system for defense attorneys is a feature of the joint and several liability doctrine they describe as "legalized extortion." In essence, they claim, plaintiffs' lawyers can file suits for amounts that are substantial—but below what the company would spend in defending the suit. For example, one chemical company points out that it sometimes has to settle nuisance suits rather than litigate them simply on a "business-decision" basis. It can not justify spending for defense several times the cost of the proposed settlement simply to prove its innocence. The chief executive of this company recalls being told by his chief counsel:

"We have a better than 98 percent chance of winning this case. But we can expect that the discovery proceedings from a lengthy court trial will cost us between $3 and $5 million in lawyers fees and lost time alone. The plaintiffs will settle for $200,000. What is your business decision?"

The chief executive officer said:

"We paid the $200,000. It was pure and simple blackmail, but I could take no other reasonable action. As a manager of an enterprise, I have shareholders to whom I am accountable. I must do what is best for them. We don't settle all of the time, however, because we really believe fighting is necessary if we are to overcome the legal crisis."[1]

In another instance, the chairman of a major steel producer says:

"We continue to find ourselves viewed as potential 'deep-pocket' defendants, and as a result are joined in numerous actions where we simply are not at fault. Once joined in these actions, however, we are faced with the equally unpalatable choices of either making a 'nuisance-value' settlement or bearing high, unwarranted defense costs with the ever-present specter of a runaway jury award. Changes should be made in the system which would work to discourage the filing of frivolous actions, limit liability to actual fault, and limit damage awards to reasonable levels of compensation for the actual injury suffered."

The chief executive of a cosmetics and fragrances firm, with nearly three-quarters of a billion dollars in U.S. sales, says: "We need a better system for handling claims of less than $25,000. The cost of outside legal service makes the defense of these claims difficult to justify financially. The so-called nuisance value of claims without merit is steadily increasing."

The product liability director at a major oil company cited another example of such tactics: His firm is frequently named, perhaps with as many as 30 or 40 other defendants, in suits in which the company is only peripherally involved. Then, he claims, the plaintiff's lawyer offers to release the company from this suit for $5,000. Such payments build a "war-chest" fund to help prosecute the case against the principal defendants. The so-called "fringe defendants" could, as noted earlier, bring action against the plaintiff's lawyer under Rule 11 of the Federal Rules of Civil Procedures. But from a practical standpoint, they do not pursue this course, finding it more costly than paying to be severed from the case.

[1]Paul F. Oreffice, "The Year Tort Reform Must Happen," *Imprimis*, Hillsdale College Center for Constructive Alternatives and The Shavano Institute for National Leadership, Volume 16, Number 7, July 1987.

- A recreational vehicle manufacturer reports that several years ago it held $100 million worth of excess product liability insurance at the cost of $52,000. Today, the firm has a fraction of that coverage but the cost for it has risen tenfold.
- One hardware manufacturing firm notes that it expects 1988 product liability-related costs to increase 40 percent to 50 percent over 1987 levels, due to insurance premium hikes.
- The vice president and general counsel for a Pennsylvania pharmaceutical firm points out that in 1984 his firm paid $72,000 for $100 million worth of liability coverage (after deductions). In 1985 the company paid $85,496 for only $18 million of coverage. By 1986 insurers were asking for $1.8 million for $15 million worth of coverage. In this case, the company sought coverage and protection from a Bahamas-based insurance firm set up by the chemical industry to provide coverage on surplus lines after sizable deductions.

Even those firms that have never had a product liability suit are adversely affected by rising insurance costs. These respondents point out that they are forced to pay higher insurance premiums in the wake of other companies' experiences. The president of one firm, which manufactures interior furnishings, points out:

> While we do not suffer the liability exposure of, say, a lawnmower manufacturer, we are still forced to carry many millions of dollars in liability insurance. The cost of this insurance significantly impacts our operating cost and increases virtually monthly due to the increased costs of other manufacturers in the "pool."

An electronics firm, which notes that the majority of its business is in supplying electronic products to the military, reports that while it has had no claims against it, its insurance premiums have more than doubled in the past few years.

A chemical company's president, representing a firm with approximately $100 million in annual sales, says, "The major impact has been huge increases in insurance cost—even with no claims or settlements against our firm."

A few firms are seeing some relief in sight:

Liability Insurers: Industry in a Bind

Product liability insurers have been criticized by both manufacturers and opponents of product liability reform. Their complaints have focused on the pricing and availability of liability insurance and on representations that the industry made to state legislators about the relationship between rising product liability litigation and the rising cost of insurance.

Whether or not these statements were ill advised, it is not valid to say that all industry leaders made such representations. Several firms pointed out that they were uncertain about what effect suggested tort reform measures would have on insurance costs and, in particular, how long it would be before insurance prices would be affected by the suggested changes.

One of the major considerations in pricing insurance is an expectation of what claims may be filed against the insurer. Company actuaries make such predictions based on current experience and their own forecasts of what these trends portend. While the actuaries rely on sophisticated econometric models in their forecasts, there is still a substantial amount of extrapolation in the process—as with most forecasts.[1]

Actuaries looking at the liability insurers' operating performance in the mid-1980s, as well as the mounting caseload of claims against their clients, could logically conclude that their companies had to increase significantly the reserves these firms must set aside for the payment of claims. (Liability insurers lost billions of dollars between 1980 and 1984.) State regulatory agencies mandate that reserves reflect the actuaries' best estimates of what such reserves must be.

Insurers had few options other than to increase premiums—sometimes in a catch-up fashion to replenish dwindling reserves. From a strategy standpoint, it also made sense to curtail the offering of insurance to classes of clients that seemed particularly prone to liability litigation. This strategy made economic—if not public relations—sense, since the firms had a duty to protect their existing clients.[2]

The insurers were caught in a classic bind. There was no way they could continue to do business as usual, that is, to provide insurance at the same rates to all of the same client groups and at the same time build the reserves that experience was teaching them that they must have. But the substantial rise in rates and the dropping of some clients were certain to trigger a public outcry. Public affairs practitioners for the industry acknowledge that whatever approach the companies took they were certain to lose the public relations war that the price increments ignited.

[1] Actuaries have particular difficulty assessing the effects of new laws, judicial decisions, and socio-economic trends (such as an increased propensity to sue).

[2] Insurers point out that they want to sell more insurance, not less, and that there must be compelling reasons for them to refrain from providing coverage.

• A supplier to major computer firms notes, "We sell our systems mainly to *Fortune* 500 companies and not to consumers. But in 1986-87 our liability insurance costs doubled and our product liability coverage decreased from $100 million to $20 million. This year (1987-88) our liability cost went down slightly, but our coverage is back up to $100 million."

A Shrinkage in Coverage

Beyond paying higher costs for the same coverage, a number of firms report having to get by with less coverage. The insurance manager for one mineral resources company says that not only are insurance premiums much greater for his company, but the "form" of insurance is also raising coverage problems. He explained:

> In addition to premiums almost three times the level charged in 1984, the deductibles now required by the insurance markets are much greater, and the form of the insurance policy is much more limited than the contracts available prior to 1986. The current form of policy offered by the insurance market to large corporations is on a "claims-made" basis rather than on an "occurrence" basis, which means that unless the claim has been filed before the contract expires, the insurance policy is worthless and the insurer will not respond to any claims made after the policy's expiration. Any company marketing a product that has a long-term, latent injury potential may find itself without adequate coverage because of such policy language.

Several of the CEOs questioned are concerned that the insurance industry itself may bear some blame in the situation. The chairman of a fertilizer company, for example, points out that in 36 years of operation his company has paid out less than $3,000 in product liability claims. But, he says, "a stable supply of coverage limits at a consistent cost has not been available. Insurers sometimes blame the product liability system, but in our judgment they need to be reminded that when one points a finger at someone (or something) there are three fingers pointing back at the accuser."

Representatives of some insurers complain that their companies are being unfairly maligned and point out that insurers are required by state law to set aside (or build up) reserves based on actuarial projections of future product liability losses. This contributes to the increase in insurance rates. But one industry lobbyist concedes that the industry's early strategy of placing the blame for insurance hikes on product liability litigation may have been a mistake—particularly since changes in the state product liability laws did not lead to rapid decreases in insurance premiums. This has led to disillusionment among some state legislators who were given the implicit promise that desired reforms, once passed, would ease the "insurance crisis."

The Role of Reinsurance

Some executives questioned say that problems with the availability of insurance are due partly to the reinsurance industry—firms that assume excess coverage risks from primary insurers. When insurance firms take on large product liability risks—such as in pharmaceuticals, aviation or automotive products—they often seek to spread this risk over as many other insurers as possible by parcelling out portions of the policy risks to a network of reinsurance companies.

However, reinsurance firms are not subject to the same set of regulations (mostly state-level) that control primary U.S. insurers. Many reinsurers are outside U.S. jurisdictions, and during the past three years several companies have reportedly defrauded firms of over half a billion dollars in uncovered losses.[2]

[2]"The Reinsurance that Wasn't," *Forbes*, September 22, 1986. p. 40.

In some instances phony reinsurance firms simply walked off with the collected premiums. Occidental Petroleum, for example, paid out $22.5 million to insure its oil rigs. The money reportedly ended up in the Swiss bank account of a fraudulent company and has not been seen since. Beneficial Finance Corporation, a subsidiary of American Centennial Insurance Company, reportedly lost $4.5 million in reinsurance premiums that were siphoned off by fraudulent means.

In addition to fraud issues, reinsurers were also buffeted by claims resulting from mass torts, as well as substantial claims from a series of natural disasters (hurricanes and similar weather-related losses). As there was a dramatic constriction in the international reinsurance market, domestic insurers also found that they could not obtain the excess coverage needed to service their clients.

Table 14: Impact of Product Liability on Direct Costs

Degree of Impact Reported	*Percent Distribution*
Major	38
Moderate	36
Minimal	26
	100%

Based on responses from 259 companies.

Table 15: Impact of Product Liability on Direct Costs by Product Type

	Percent Distribution			
Degree of Impact Reported	*Consumer Durables*	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Major	39%	31%	44%	40%
Moderate	48	29	34	39
Minimal	13	40	22	21
	100%	100%	100%	100%

Based on responses from 259 companies.

Table 16: Median Increase in Direct Costs 1984-87

Percent of Increase	*Percent Distribution*
Less than 1%	6
1-2%	12
3-5%	32
6-10%	13
11-20%	8
More than 20%	29
	100%

Based on responses from 137 companies.

Table 17: Impact of Product Liability on General/Administrative Costs

Degree of Impact Reported	*Percent Distribution*
Major	35
Moderate	40
Minimal	25
	100%

Based on responses from 258 companies.

Table 18: Impact of Product Liability on General/Administrative Costs by Size of Company (annual sales)

	Percent Distribution						
Percent Increase	Less than $50 million	$50-99 mil.	$100-199 mil.	$200-499 mil.	$500-999 mil.	$1-5 billion	More than $5 bil.
Major	53%	39%	39%	26%	35%	28%	31%
Moderate	20	33	39	51	35	42	53
Minimal	27	28	22	23	30	30	16
	100%	100%	100%	100%	100%	100	100%

Based on responses from 258 companies.

Table 19: Average Increase in Direct Costs 1984-1987 by Product Type

	Percent Distribution			
Degree of Increase Reported	*Consumer Durables*	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Less than 1%	–	3%	3%	2%
1-2%	13	28	10	32
3-5%	40	28	25	23
6-10%	13	9	17	10
11-20%	–	6	3	10
More than 20%	34	26	42	23
	100%	100%	100%	100%

Based on responses from 138 companies.

Table 20: Average Increase in Direct Costs 1984-1987 by Size of Firm (annual sales)

	Percent Distribution						
Percent Increase	Less than $50 million	$50-99 mil.	$100-199 mil.	$200-499 mil.	$500-999 mil.	$1-5 billion	More than $5 bil.
Less than 1%	–	–	–	7%	5%	–	–
1-2%	25	33	29	10	23	23	20
3-5%	13	11	24	40	23	32	10
6-10%	–	11	12	20	18	3	20
11-20%	–	–	–	7	–	13	10
More than 20%	62	45	35	16	31	29	40
	100%	100%	100%	100%	100%	100	100%

Based on responses from 127 companies.

Table 21:
Median Increase in General/Administrative Costs
1984-1987

Percent of Increase	*Percent Distribution*
Less than 1%	8
1-2%	12
3-5%	34
6-10%	17
11-20%	13
More than 20%	16
	100%

Based on responses from 131 companies.

Table 22: Average Increase in Direct Costs 1984-87

Percent of Increase	*Percent Distribution*
Less than 1%	2
1-2%	23
3-5%	27
6-10%	12
11-20%	6
More than 20%	30
	100%

Based on responses from 138 companies.

Table 23:
Average Increase in General/Administrative Costs
1984-1987

Percent of Increase	*Percent Distribution*
Less than 1%	2
1-2%	29
3-5%	29
6-10%	14
11-20%	10
More than 20%	16
	100%

Based on responses from 133 companies.

Table 24: Average Increase in General/Administrative Costs 1984-1987
by Size of Firm (annual sales)

	Percent Distribution						
Percent Increase	Less than $50 million	$50-99 mil.	$100-199 mil.	$200-499 mil.	$500-999 mil.	$1-5 billion	More than $5 bil.
Less than 1%	–	–	5%	–	–	3%	–
1-2%	50	13	26	35	35	19	14
3-5%	12	37	37	31	35	23	14
6-10%	13	13	11	14	20	23	–
11-20%	12	12	5	10	5	9	29
More than 20%	13	25	16	10	5	23	43
	100%	100%	100%	100%	100%	100%	100%

Based on responses from 122 companies.

Table 25:
Average Increase in General/Administrative Costs 1984-1987 by Product Type

Degree of Increase Reported	Percent Distribution			
	Consumer Durables	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Less than 1%	–	3%	–	4%
1-2%	50	29	29	24
3-5%	42	26	34	24
6-10%	8	11	17	16
11-20%	–	14	6	12
More than 20%	–	17	14	20
	100%	100%	100%	100%

Based on responses from 133 companies.

Table 26:
Pricing Strategies Used by Small Firms to Cope with Liability Costs

Strategy Employed	*Percent Distribution*
Absorbed increased costs	48
Raised prices to recover costs	12
Raised prices and absorbed costs	22
Did none of the above	18
	100%

Based on responses from 264 companies.

Table 27: Firms' Strategies in Dealing with Insurance Availability

Strategy Employed	*Percent Distribution*
No change in insurer	70
Operate without insurance	15
Form captive insurer	15
	100%

Based on responses from 264 companies.

Chapter 3

Consequences for Management and Operations

The Conference Board's survey asked about seven strategic decisions that could be affected by the product liability system. And the survey data suggest that product liability litigation—as well as the potential for it—has altered managerial behavior in many companies. As expected, companies with actual product liability experience cite more adverse impacts (see Tables 28 and 29). But, as noted, even among firms that have no direct experience with the product liability system, one in ten companies discontinued product lines. Nearly the same number have decided against introducing certain products because of product liability worries. The data show that 8 percent of the companies have closed certain production plants as a result of discontinuing product lines that were particularly liability prone. And almost twice that number have laid off workers as a direct result of product liability experience.

Several of the adverse effects are, of course, interrelated. Many of the firms that decided against introducing new products also discontinued product research in that area. A fifth of the companies with actual product liability experience report the discontinuance of selective product research. Relatively few companies report moving production offshore as a way of forestalling product liability litigation. More than one-fifth of the firms believe that they have lost market share to foreign competitors because of product liability considerations—principally as a result of charging higher prices to compensate for the cost of the product liability system.

About a fifth of the firms have decided against acquiring or merging with a firm that has a product liability exposure. Industry experience in the past several years is replete with examples of companies that have acquired what they believed to be promising firms only to discover that these new additions came complete with an unseen set of product liability suits. (The suits had not been filed at the point of merger or acquisition, but the product lines were subject to suit and such litigation did ensue after the merger.) One company, for example, discovered that the firm it purchased had produced a model of gas furnace that was capable of pumping carbon monoxide into the homes it was heating. In another case, a recently acquired firm was discovered to have been burying toxic wastes in its backyard and polluting a nearby aquifer.

Impact on New Products

The effect of the liability system on new products and on innovations is widespread (see Tables 28-30). About a third of all the firms surveyed—and nearly half of those reporting major impacts—have decided against introducing new products because of liability fears. And 58 percent of those experiencing a major impact have discontinued some of their affected product lines. The following examples illustrate this dilemma:

- In the aircraft sector, plagued by product liability litigation, manufacturers of more advanced equipment may be withholding developments because of fears of liability. The president of Unison Industries, Inc., of Rockford, Illinois, said his firm is withholding from the market a new and advanced electronic ignition system for light aircraft because of the liability risk that might result from its release and use.[1]
- The chairman of a diversified manufacturing firm said, "We were forced to withdraw from selling secondary pollution abatement devices since no insurance could be found to cover possible liability exposure."
- A drug manufacturer explained, "We have been forced to discontinue sale of therapeutically beneficial drugs because of excessive product liability costs. In the future, unless balance is restored to the product liability system, more and more health-care companies will be deterred by liability concerns from pursuing certain areas of research and introducing innovative new products. Ironically, the victims of the excesses of the product liability system will be the consumers, the very persons the system purports to protect."
- The president of another pharmaceutical firm says that the system has "substituted uncertainty for predictability in the tort system and resulted in the loss of product liability insurance and the discontinuance of sales of important drugs by pharmaceutical firms."
- In early 1986, the pharmaceutical firm of G.D. Searle & Co. decided that even though its intrauterine contraceptive, Cu-7, was approved by the Food and Drug Administration

[1] For details, see *An Update on the Liability Crisis*, Tort Policy Working Group, U.S. Department of Justice, March 1987, p. 19.

as safe and effective, the company should discontinue this line of business. Searle had reported spending $1.5 million in 1985 to defend itself against four suits—each of which the company won. Looking at the potential sales value of its product, $11 million 1985, the company decided it made no economic sense to continue to produce products which were targets of suits and for which no liability insurance was available.

- The chairman and CEO of a major health-care equipment producer says that as a result of the product liability system, the firm has taken products off the market, turned down innovative and medically beneficial new product ideas, and decided against otherwise attractive acquisition opportunities.
- The chairman of a $10 billion chemical and plastics firm points out that product liability, which cost his firm over $100 million annually in legal and insurance costs, has forced the company to withdraw from the market one of its major and most successful products. Further, he says, the system has also halted research in several potentially fruitful fields. His company's legal department is the fastest growing group within the firm.
- The firm of Wepco, Inc., of Vienne, Virginia, manufactured hand and foot driving controls for handicapped drivers. Wepco products were endorsed by the Veterans Administration and the firm had never been sued successfully. Nonetheless, its product liability insurance costs increased so dramatically that in September, 1986, it was forced to close.

Often, it appears that it is the issue of unpredictability, as mentioned on page one, that most vexes CEOs intent on new product development. The chairman of a major health-care products firm leaves little doubt about the impact that liability has on corporate planning, reporting:

> The threat of enormous and unpredictable liability continues to weigh heavily in our decisions relating to the development of new products and to improvements to existing ones. This is particularly significant in pharmaceuticals and other high-technology health-care products. In cases involving these products jurors are left free to second-guess the weight of impartial scientific opinion and the Food and Drug Administration, to find manufacturers at fault, and to award multimillion-dollar verdicts. As a result, valuable products whose potential profitability is outweighed by the risk of enormous liability never see the light of day.

Certainly, the specter of what has happened to products that offered customers a substantial benefit influences companies' decision making. The case of various vaccines illustrates the cost/benefit equations that manufacturers consider in such situations. The general counsel for one pharmaceutical firm noted:

> There are over 150 product liability suits pending against vaccine manufacturers. Wyeth was hit in one case for $7.5 million. The dollar demand against the vaccine by plaintiffs is over 200 times the total annual sales of the vaccine, which has been given universally to American children since the 1940s. Before it was used, 7,000 to 9,000 children died every year from whooping cough. In 1984 there were no deaths [from whooping cough]. But deaths are bound to increase if there is no adequate supply of vaccine. So the situation causes the health-care system in many circumstances to deliver lower quality service at higher costs.[2]

Some Beneficial Effects

Even the most vociferous critics of the product liability system concede that, on occasion, the system acts to improve product safety. Nearly half of the companies with actual product liability experience, as shown in Table 31, have improved their product use and warning materials. And a third say that they have redesigned their product lines to improve product safety. Even those without actual liability experience have been moved to make such improvements (see Table 32). But some believe that safety improvements would have been made anyway. For example, the chairman of a major agricultural equipment firm notes:

> We make frequent safety-oriented redesigns and improvements in product usage and warning information. While avoiding liability claims is one motivating factor, preventing death or serious injury and protecting the reputation of the product are more important. It would not be fair or adequate to say that the "system"—and in particular the excesses in the system which we would like to see changed—has "caused" or "resulted" in these improvements.

The president of a major plastics company comments:

> The product liability system has increased cost to our company and to American industry in general. It has also resulted in improved safety and warnings. The question is whether the result has been achieved efficiently and justly. We think not. In many cases the cost has not been distributed fairly and [as a result] worthy companies have gone out of business.

Liability and Overall Innovation

In sum, a number of chief executives say that fear of liability has had a chilling effect on their companies' entire research effort. They point out that with many new products it is impossible to know with absolute certainty the ways in which the product may be abused or misused by customers and, regardless of the contributory negligence of such users, manufacturers may find themselves saddled with a liability claim. Radically new technologies pose an even greater threat because they may have completely unforeseen impacts. While the evidence for the overall impact of liability on innovation is largely anecdotal, and there is no definitive measure of the dampening effect that fears of liability litigation may have on invention, testimony from various researchers as well as from executives supports the existence of such an impact. A research scientist at the Lawrence Livermore National Laboratory in California, who has worked on a number of new

[2]George S. Frazza, "Product Liability: A Crisis of Cost and Uncertainties," *Worldwide*, a magazine of the Johnson & Johnson family of companies, October 1985, pp. 1-4.

product ventures, says, "There's clearly a chilling effect. It's becoming difficult to get venture capital for new ideas. People are afraid of potential liability."[3]

Ironically, some corporate attorneys point out that their firms are reluctant to introduce certain safety-related measures because of fears that state-of-the-art defenses may then no longer hold up. Further, introducing a modification that makes existing products safer can itself create liability risks. The company may be called on to modify all existing products in customers' hands or it may risk liability should one of these customers be injured. These companies are also "whipsawed" when a competitor introduces a new or safer product since that innovation then defines the state of the art.

Innovation may also be victimized by the "deep-pocket" litigation strategy in which the wealthiest organization involved in a product becomes the favorite target of suits. Universities, as well as certain major corporations, have developed new technologies and licensed them to smaller firms with little in the way of financial resources. Should the technology yield products that become the target of liability suits, plaintiffs may sue not only the company that manufactured and distributed the product but also the institution that developed the underlying technology.

The University of Wisconsin, for example, has a long history of developing new products ranging from pharmaceuticals to rodenticides. It has traditionally licensed many of its technological breakthroughs to smaller firms. The general patent counsel for the university says, "There is some sincere questioning whether we should license to small businesses at all."[4]

Others point out, however, that serious consideration is needed before certain technologies are "unleashed" on the public. The executives questioned say that reasonable regulatory safeguards to prevent catastrophic damage by materials not thoroughly tested are necessary. But they believe that there are many more instances in which innovation is inhibited because researchers and companies simply fear the unknown consequences of product innovation. While there is no absolute indicator for the number of new products being brought to the marketplace, or for the number of innovations being developed, one index is useful to watch: the number of patents granted to U.S. and foreign citizens. In 1979, according to the U.S. Patent office, U.S. citizens obtained 62 percent of all the patents issued. By 1987 they were obtaining only 53 percent of the patents granted. Foreign innovators are now getting nearly half of all the patents issued by the U.S. Patent office.

[3]Proctor, Paul, "Product Liability Costs Cited as Key Factor in Delivery Slump," *Aviation Week and Space Technology*, July 27, 1987, p. 55.

[4]Broad, William J., "Does the Fear of Litigation Dampen the Drive to Innovate?" *The New York Times*, May 12, 1987, p. C1.

Table 28:
Adverse Impacts Cited by Responding Companies Based on *Actual* Liability Experience

Type of Impact	*Percent of Firms Reporting Action*
Closed production plants	8
Laid off workers	15
Discontinued product lines	36
Decided against introducing new products	30
Decided against acquiring/merging	17
Discontinued product research	21
Moved production offshore	4
Lost market share	22

Based on responses from 180 companies.

Table 29:
Adverse Impacts Cited by Responding Companies Based on *Anticipated* Liability Problems

Type of Impact	*Percent of Firms Reporting Impact*
Closed production plants	1
Laid off workers	1
Discontinued product lines	11
Decided against introducing new products	9
Decided against acquiring/merging	5
Discontinued product research	4
Moved production offshore	1
Lost market share	–

Based on responses from 84 companies.

Table 30: Overall Adverse Impacts Cited

Type of Impact	*Percent of Firms Reporting Impact*
Closed production plants	9
Laid off workers	16
Discontinued product lines	47
Decided against introducing new products	39
Decided against acquiring/merging	22
Discontinued product research	25
Moved production offshore	4
Lost market share	22

Based on responses from 264 companies.

Table 31: Beneficial Impacts Cited by Responding Companies Based on *Actual* Liability Experience

Type of Impact	*Percent of Firms Reporting Impact*
Improved safety of products	35
Redesigned product lines	33
Improved product usage and warnings	47

Based on responses from 264 companies.

Table 32: Beneficial Impacts Cited by Responding Companies Based on *Anticipated* Liability Experience

Type of Impact	*Percent of Firms Reporting Impact*
Improved safety of products	19
Redesigned product lines	13
Improved product usage and warnings	21

Based on responses from 264 companies.

Chapter 4
Reforming the Product Liability Tort System

Most, if not all, of the CEOs responding to the survey favor some form of product liability tort reform. Even those companies reporting a minimal effect on their firms support reform efforts, the Board's survey shows. CEOs were asked to rank which of ten suggested tort reforms would be of most value to their companies; the results are shown in Table 33 and individual reforms are described in order of concern to the respondents in the sections that follow.

How significantly companies are affected by increases in litigation and awards has an impact on their ranking of tort reform measures. Companies that report major or moderate levels of impact are substantially in agreement as to the kinds of tort reforms they favor and their rank order preference. But firms reporting a minimal impact tend to put primary emphasis on reforms that would limit pain and suffering damages and less emphasis on issues like joint and several liability—matters of primary concern to firms that have already been defendants in multiple party suits.

The concept of federal preemption of state tort liability laws received surprisingly limited support. This seems, on first glance, to fly in the face of pressure from larger companies for tort product liability reform at the federal level. There are two factors at work here. First, there is widespread belief that despite recent activity in the House of Representatives, the passage of a federal product liability reform act would face considerably more difficulty in the Senate. Second, in looking at some of the provisions incorporated by the House of Representatives in HR-1115—which addresses product liability issues, not general tort reform—some chief executives point out that tort liability statutes and case law in their states are already "better" than what the bill is offering (see page 26).

Most executives do not expect antitrust laws for the insurance industry, which some advocates suggest to control premium increases and thus minimize the effects of product liability, to have any real impact on the costs of the product liability insurance system.

Overall, many see substantial progress in tort reform. Others believe the process has slowed down. John V. Reistrup, editor and publisher of *Liability Week,* notes that:

> The great tort reform crusade of the mid-1980s began as World War I did, with a great sweeping attack across a broad front. Now, like that conflict, it appears to be bogging down in an unending trench warfare punctuated by sporadic attacks on specific strongholds.[1]

On the other hand, supporters of tort reform point out that many states had already passed specific bills in 1985 and 1986, prior to Reistrup's assessment.

Modifying The Strict Liability System

The overwhelming majority of CEOs polled disagree with the basic principles of strict tort liability (as expanded by the courts and coupled with legal doctrines) which allow recovery from multiple sources. They would like to see reforms that would modify—if not eliminate—the strict liability doctrine and replace it with a fault-based system. But legislators, product liability reform lobbyists, and others involved with federal tort reform believe there is little possibility that the strict liability doctrine will be entirely overturned. At present the doctrine is not under serious challenge in the courts—primarily because state reform efforts have not included significant alteration in the doctrine.

The present strict liability doctrine represents the results of a decades-long evolution of tort liability law. Scholars see three distinct phases in its history.[2] At the earliest stage, in the mid-nineteenth century, the courts relied on the privity rule and placed the major burden on customers to prove product defects and negligence. In other words, product users could only sue the person from whom the product was purchased, not its manufacturer. The requirements of proof were rigorous, and corporate defendants were often able to escape blame using defenses of contributory negligence or the assumption of risk.

The second stage of this evolution required a manufacturer to supply products that met its own performance or design

[1]John V. Reistrup, "The Final Frontiers," *The National Law Journal,* December 7, 1987, p. 13.

[2]Richard A. Epstein, *Modern Product Liability Law,* Quorum Books, Westport, Connecticut, p. 5.

standards. Customer misuse or abuse of the product could obviate any claim.

The third stage began in the 1950s with several cases involving food products. The resultant doctrine was described in 1965 with the publication of the Restatement (Second) of Torts.[3] The relative duties of the manufacturer and the customer were substantially redefined by this point. The manufacturer could no longer rely on the fact that the firm produced a product, as represented to the buying public, that met its own standards of quality. Increasingly, reckless use of the product, neglect of its maintenance, and similar contributory negligence came to be excused by the courts.

Some argue that this evolution has gone too far. A manufacturer comments, "The courts and insurance industry have to come up with a way to fairly award violated parties for damages incurred through negligence, as opposed to blatant disregard for posted warnings and operating instructions."

One machine tool company plagued by liability suits notes that, "The major problems we encounter come from modifications made to our equipment by customers, resulting in injuries to their employees. A change to a fault-based system would be far more equitable to us."

Current efforts at federal product liability reform would maintain the strict liability doctrine for product design defects and for broad classes of warnings, but would provide a state-of-the-art shield. They would also insulate manufacturers of drugs and medical devices against products that are "unavoidably unsafe," that is, pharmaceuticals with a low incidence of side effects in a large population of users.

Curtailing Joint and Several Liability

Many CEOs point to abuses within the doctrine of joint and several liability as symptomatic of what is wrong with the current tort liability system. The prospect for curbing what they see as abuses arising from the doctrine of joint and several liability has great appeal to CEOs, and they see it as among the reforms most likely to occur (see Table 34). Tort reformers succeeded in getting more than 28 states to change the "rules of the game" on joint and several liability in 1986 and 1987, but in some states these reforms are the subject of court challenges.

Tort reformers would prefer, naturally, to have joint and several liability abolished completely. Instead, the states that have modified this rule tend to create various exceptions, some of which can prove troublesome to corporate defendants. For example, in some instances, the exception provides that joint and several liability would apply to defendants when it can be shown that the tort was "intentional" or that it involved a specific class of offense (such as dumping hazardous waste).

The chief executive officer of a major chemical and pharmaceutical company—which has seen its insurance costs go up by several hundred percent in the last two years—believes that joint and several liability may be one of the culprits in the premium increases. Several years ago, he says, a young California man purchased chemicals from a store to use in making illegal fireworks. The particular chemicals were manufactured in bulk by this executive's company, as well as by other firms, then resold to a distributor and in turn to a retail store, which repackaged the chemicals but provided no warnings or instructions for their use. The young man took the chemicals home, attempted to make fireworks, and in the process was seriously injured by an accidental explosion. The store owner, the chemical company, and others were joined as defendants in a liability case. The chemical company's CEO points out that the firm spent a great deal of time and money before it was able to sever itself as a defendant from this case. The CEO says:

> One of the phoniest of these [product liability or "personal injury"] distortions is the concept of joint and several liability, which allows the plaintiff to sue anyone and everyone who might conceivably share in the responsibility for an accident. It is possible under this concept that only one of the defendants, although found to be only minimally at fault, may be forced to pay the entire judgment, while co-defendants found to be chiefly at fault, but with little or no resources, wind up paying nothing.[4]

Capping Pain and Suffering Damages

CEOs are worried about the "open-ended" aspects of liability awards for pain and suffering damages. Individuals damaged by a manufacturer's product can recover not only the actual expense of medical claims and economic costs such as loss of wages, but also an undefined sum in compensation for the pain and suffering that the injuries inflicted. Jury awards can range from a few hundred dollars to more than a million dollars for such damages. One of the most uncertain consequences in a liability suit is the amount that so-called "runaway" juries might award for non-economic damages—principally involving claims for pain and suffering. These amounts can and frequently do exceed the amounts paid to plaintiffs for "actual" damages—loss of wages, property damage, medical costs, and other economic damages.

At the state level, various caps or limits have been placed on non-economic damages, but these do not always provide the kind of protection that advocates of tort reform had envisioned. The state of Idaho, for example, enacted a $400,000 cap on such damages but then created a 1992 sunset clause. Sunset clauses, by which legislation becomes ineffective after a specific date, destroy the very predictability that insurers must rely on in creating reserves. They may even encourage some plaintiffs' counsel to delay filing of suits (under existing statues of limitations) until after the sunset time limit.

[3]The Restatement (Second) of torts is a synthesis of the law, as published by leading scholars, but is not a statute. Courts and legislatures do, however, rely on its principles.

[4]Edward A. Tuttle, "The Product Liability Crisis," remarks delivered at the Pennwalt Corporation annual meeting, April 23, 1986.

The constitutionality of caps on non-economic damages has been reviewed by the Supreme Courts of various states and by federal district courts. The Florida Supreme Court found the State's $400,000 cap on non-economic damages to be unconstitutional, and a Federal District Court ruled that the State of Virginia's limits on pain and suffering damages were unconstitutional. These rulings tend to be focused on a single class of claims, such as medical malpractice. At the same time, other state courts have upheld the constitutionality of non-economic damages applied to all personal injury claims. In the end, the constitutionality of these reforms may be reviewed by the U.S. Supreme Court.

In addition to ruling on the constitutionality of caps on pain and suffering damages, some courts have also been active in reducing jury awards for such damages. For example, the U.S. Courts of Appeals for the Third Circuit affirmed a Federal District Court's reduction of a jury award for non-economic damages (due to a product-related fall in a supermarket) from $900,000 to $575,000. The Court of Appeals then further reduced it to $235,000.[5] In another case, the U.S. Court of Appeals in the Seventh Circuit reduced an award for pain and suffering from $350,000 to $175,000. This was an award to the estate of a man who had died six months after surgery and was for pain and discomfort during that period. In disallowing the original amount for pain and suffering damage, the court said, in part, that "there is justified public concern with extravagant tort awards, and it is the duty of an Appellate Court to keep these awards within reason."[6]

Limitations on Attorneys' Contingency Fees

The plaintiffs' bar gets a lot of attention from CEOs concerned with tort reform, who believe that the U.S. contingency fee system disproportionately awards plaintiffs' counsels for time and energy spent in representing their clients. These "windfall" profits provide compelling incentives for attorneys to file claims and complaints that they might not otherwise file, executives argue. This is particularly true, it is said, when attorneys handle multiple, serial cases for the same type of injury against the same defendant. While few of those polled believe that contingency fees will disappear from the U.S. legal system, many argue for a restructuring of the fee system that will, in effect, place caps on the amount plaintiffs' attorneys can earn. Some states have enacted reforms that provide for a sliding scale of fees, depending on the size of these awards. There has been relatively little in the way of challenge to these reforms. Executives surveyed also support changes that would encourage plaintiffs to compare contingency-fee rates among attorneys.

[5]As reported in *Liability and Insurance Bulletin*, Volume 2, Number 5, August 24, 1987, p. 4 (Gumbs vs Pueblo International, Inc., CA3, Nos. 86-3047 & 86-3285).

[6]Kwasny vs United States of America, CA-7 No.86-2694.

The contingency-fee system is a uniquely American institution. Most other nations require that plaintiffs compensate their attorneys whether or not the litigation is successful. Many require the losers in litigation to pay the legal costs of both plaintiffs and defendants. Both advocates and opponents of tort reform concede that a majority of product liability litigation is carried on by attorneys who are compensated on a contingency-fee basis.

Opponents of tort reform are skeptical that efforts to revamp the contingency-fee system will have any real impact. They point out that a number of states have created "sliding scales" which reduce the percentage of settlements that attorneys can obtain. But these revised fee structures, they note, do not seem to have altered significantly the number of suits filed. There is still, they say, more than enough economic incentive to file such suits. Few, if any, tort reformers have offered the hope that the contingency-fee structure can be so dramatically altered that it would provide little incentive for filing suits.

Advocates of tort reform point out that many "borderline" suits and claims, which they describe as frivolous or unwarranted, might be eliminated by changes in the contingency structures. On the other side, opponents of such reforms point out that the courts already have a variety of mechanisms to chastise and punish attorneys who bring frivolous claims. Defendants themselves can countersue for unwarranted or harassing litigation. There has been an upswing in the use of procedures, such as Rule 11 of the Federal Rules of Civil Procedure, which authorizes courts to punish attorneys for the filing of frivolous cases or for negligently representing their clients. (See box on page 24.)

Advocates of tort reform also claim that the contingency fee system contributes to the proliferation of lawsuits against certain "target defendants." For example, a company may defend itself about once a year—successfully—in product liability suits. Once it loses a single case, however, a dozen cases per year may be filed against it.

Supporters of the contingency fee system describe it as "the poor man's key to the courthouse," contending that poor persons, or even those of modest income, could not afford to press legitimate claims against manufacturers if they had to incur all the costs of litigation and risk losing such funds in an adverse decision. Supporters of the contingency fee also argue that attorneys incur significant out-of-pocket costs. They also see a substantial risk in attorneys' "investment of professional time and resources" in a liability action—a risk that, consistent with our economic system, should provide for high rewards.

Those who advocate reform of the contingency fee system contend that some lawyers are unjustly enriched in large award cases, earning millions of dollars in fees for only a few months' investment of professional time. And they suggest that, if the contingency fee system is not to be abolished, it should be significantly modified with a sliding scale of percentage compensation that diminishes as the size of the award increases.

Curbing Frivolous Claims

Rule 11 of the Federal Rules of Civil Procedure allows a lawyer to be sanctioned for filing suits without adequately investigating whether the complaints have true merit. This rule can also be applied against attorneys—on the plaintiff or defendant side—who engage in illegal harassment or procedures designed to increase the cost of litigation or delay it. Federal judges have begun to use this weapon against attorneys who violate the rule. According to studies conducted at Fordham University Law School, more than 500 lawyers have been sanctioned under Rule 11 by federal judges during the past few years. Many observers concede, however, that only a small fraction of all practitioners might be subject to such sanctions.

Besides being sanctioned by the courts, attorneys have also been increasingly subject to malpractice claims when they fail to represent their clients adequately in product liability litigation or any other form of legal representation. Prior to 1965, legal malpractice suits were a rarity. But, at present, it is estimated that one in 17 lawyers will be charged with malpractice, and in some areas of the country (such as southern California), the rate may be as high as one in six.*

*According to studies conducted by Prof. William L. Tabac, Professor of Law at Cleveland State University, cited by Patricia Bellew Gray, "Under Fire: Regulators, the Courts and Clients Bear Down on Lawyers," *The Wall Street Journal*, August 21, 1987, p. 17.

CEOs surveyed for this study point out that it is just "common sense" to believe that if there was less reward there would be less incentive for attorneys to seek out product liability cases.

The Matter of Punitive Damages

For many CEOs, punitive damages can be the "wild card" in any liability litigation. They are concerned that *punitive* damage awards often exceed awards for *actual* damages. Punitive damages can also be a nightmare for attorneys defending corporations because there is no practical way of controlling jury members once they decide to punish a corporate defendant for an alleged tort. Tort reformers at the state level have sought to limit punitive damages, with some success. During the past two years more than 22 states passed such legislation. In some instances they placed explicit caps on punitive damages, citing specific amounts ranging from $200,000 to $350,000. Other states have devised formulas based on figures like the defendant's annual income or the profit derived from the tort committed.

In those states where specific dollar amounts were not set, reformers were successful in raising the standards of evidence required to assess punitive damages. Sometimes this results in curious additions to the lexicon of legal complaints. For example, California legislators—relying on existing legal doctrines—decided that in order for punitive damages to be awarded, the defendant must be guilty of "despicable conduct." Presumably, a series of cases will define, for both the general public and legal practitioner, what "despicable conduct" entails.

As in the case of pain and suffering damages, challenges based on issues of state constitutionality—and, perhaps, eventually on federal constitutionality—have been mounted. Courts do have the authority to reverse reforms that set a limit on punitive damages. A recent Virginia case illustrates this point.

U.S. District Judge James H. Michael, Jr. affirmed his earlier ruling that Virginia's limit on medical malpractice awards violates the right to trial by jury as guaranteed under the U.S. Constitution. The State of Virginia had originally set a limit of $750,000 as a damage cap in medical malpractice suits. It raised that cap to $1 million in 1983. But in a case that Judge Michael heard (Boyd vs Bulala, 647s. Supp. 7/81-W.D.Va.), an obstetrician was found responsible for injuries suffered to a newborn, including its subsequent mental retardation. Judge Michael found that the State's caps on compulsory and pain and suffering awards abridged the right of citizens to a jury trial—and the power of juries to make such awards. The judge noted that "in colonial America, the Crown's use of bench trials to circumvent the right to a jury was one of the chief grievances of those who advocated independence."[1]

Statute-of-Limitation Reforms

In a number of jurisdictions, consumers can sue manufacturers for products that are literally decades old. In other states, once a set age limit has been reached, the manufacturer can no longer be sued for the product unless a special circumstance of negligence arises. At present most reforms aimed at this issue are focused at the state level, and there have been few challenges to the legality of such reforms.

The CEOs questioned would like to be relieved of the burden for "old" products—many of which may be more than 50 years old. They make the point that it is extremely difficult to plan and allocate corporate resources for such potential "time bombs." The president of one multibillion dollar automotive component company notes:

> Current strict liability awards are outrageously expensive. Without evidence of negligence at the time of manufacture or sale, we have had million-dollar costs and expenses based on the use of ten- to forty-year-old products. In the absence of relief, we must recognize the prospect of catastrophic losses.

In a perverse way, some CEOs explain, the product liability system actually imposes a more onerous burden on firms that make high-quality, long-lasting products. With no time limit on liability, such producers face exposure to product liability suits over a longer period of time. "The longer the time span

[1]Alan Cooper, "U.S. Judge Reaffirms Ban on Virgina Malpractice Cap," *The National Law Journal*, November 30, 1987, p. 10.

during which a product is used, and the larger the number of people using it," one executive explains, "the greater the liability exposure the firm faces."

An extreme case is the elevator industry. As the general counsel of a major U.S. elevator supplier points out:

> Equipment lasts for 100 years or more, and it is not unusual for manufacturers to be sued for equipment that has been in service for more than 70 years. On our equipment alone we transport more than 60 million people per day in this country. Typically, alleged accidents happen without any witnesses or any other clear evidence that an accident has occurred. In nearly one-third of the accidents, our first notice that an accident may have taken place will come two or three years after the accident, when we are served with a summons and complaint. Because it takes seven to ten years from the date of an accident to the payment of a verdict, new competitors avoid any significant product liability expenses for the first decade or so and can price equipment and service accordingly. Any further movement toward strict liability would threaten to bankrupt all [domestic] elevator and escalator manufacturing companies, because of the sheer number of passengers carried and the inevitable number of alleged minor injuries from tripping on unleveled elevators or door strikes.

In addition, damages may occur over a prolonged period of time. (This is particularly true for environmental torts, although also possible in product liability torts.) In environmental torts the situation is complicated by the fact that insurers may have exclusion clauses which limit coverage for pollution to "sudden and accidental" incidents. When manufacturers attempt to recover from their insurers under what they believe to be coverage for gradual environmental pollution, they find that their coverage is limited to "accidental" pollution. For example, the General Host Corporation allegedly discharged salt brine over a prolonged period from its manufacturing operations into a local aquifer. Kansas residents and farmers won a $13.6 million judgment against the company. The company attempted to recover this expense from its insurer, American Motorist Insurance Company, but the U.S. District Court confirmed that the policy clearly limited the protection to "accidents." The U.S. District Court for Kansas, commenting on the attempt of the plaintiff to recover from the insurer, said, "The pollution clause is not ambiguous. The language is clear and plain, something only a lawyer's ingenuity could make ambiguous."[1]

State-of-the-Art Defenses

In the normal course of events, as manufacturers learn more and more about how their products are used, they make improvements in product design. These improvements may consist of safety-related additions or changes making the product easier and safer to use. The problem, CEOs report, is that often a large number of products in the marketplace do not have the newer modifications or safety features. When sued for a product "defect"—which may mean the absence of a currently available safety feature on an old product—manufacturers would like to rely on a state-of-the-art defense. In other words, they would like to say that the product was manufactured using the best available technology—not the most customary practice—in use at the time. They believe they should not be required to notify users when better or safer designs emerge.

Manufacturers also assert that they should not be required to "retrofit" all their older products with new safety features. Opponents of this view argue that manufacturers would then have little incentive to recall products for safety-related retrofitting or to improve instructions for the use and maintenance of existing products.

Some staff members in Congress are also concerned that state-of-the-art protection might exonerate manufacturers who discover that a product was always defective—not just that safety devices were unavailable at the time of production—but neglect to remedy it or advise holders of the product. Further, they question, what of those manufacturers who only advise holders in such a cursory or inefficient manner that many purchasers would be uninformed of the danger?

Little case law addresses this particular issue. Product liability lawsuits often include allegations of failure to recall or remedy defects of which manufacturers had become aware. But the vast majority of such cases do not go to trial, nor are they reviewed by the appellate courts. Thus, there is relatively little legal precedence upon which companies can rely.

The Collateral Source Rule

CEOs see a certain injustice in the current rules governing "collateral source" payments to plaintiffs. Tort reform advocates argue that plaintiffs should not be allowed to "double-dip"—be compensated twice for the same injury. They say that in many instances plaintiffs' insurance, or coverage provided by their employers, pays part or all of the cost associated with an injury.

Nevertheless, in a number of jurisdictions these payments cannot be deducted from the total costs that the plaintiff is found to have suffered. Thus, jurors award monies which are, in the view of the reform advocates, double payments for the same injury. However, the plaintiff's bar argues that the plaintiffs often have paid—either wholly or in part—for the insurance that provided for payment of medical expenses, lost wages and similar costs. The plaintiffs' attorneys argue that their clients should not be "penalized" for having the foresight to obtain and pay for insurance. Why, they ask, should manufacturer-defendants gain the benefit of the insurance protection that plaintiffs had the initiative to obtain? Employers, however, point out that often they pay all—or the major part—of the premiums for such insurance.

Several states have modified the collateral source rule but, depending on their construction, such reforms are not always held to be legal and constitutional. And in some cases ob-

[1] American Motorist Insurance Company vs. General Host Corporation, DC, Kan, No. 84-1802-T.

servers of the industry have agreed with these rulings. In a report entitled "Some Tort Reforms Deserve to be Overturned," *Business Insurance* notes:

> The Kansas State Supreme Court threw out the state's law allowing evidence of a plaintiff's payments from collateral sources in medical malpractice cases. The courts said it violated the state's equal protection guarantees by potentially discriminating against a class of tort claimants: those filing medical malpractice claims. Further, the court said the law gave preferential treatment to health-care providers, because a doctor guilty of malpractice would benefit from the law while another professional would not.[9]

As Table 34 illustrates, this reform is rated as one of the "most likely to occur." Tort reform opponents say that this is likely to be instituted and is an area in which they would be most willing to give ground.

Federal Preemption of State Tort Liability Laws

Although some efforts focus on the federal preemption of state product liability laws, chief executive officers do not rank this very high among the changes they would most like to see enacted. State-based reform efforts—larger in overall scope—apply to all personal injury claims, not just those caused by products. Thus, some executives believe that broad-scale tort reform within their own states is or would be more comprehensive and meaningful than what could be achieved by product-related liability reforms at the federal level.

At the same time, several CEOs noted their opposition to federal intervention in yet another area of business. Their philosophical arguments are summed up by one attorney, participating in a 1986 Duke University conference on professional liability, who said:

> A decent respect for federalism argues strongly against direct or indirect federal intervention in the civil justice system. Part of the genius of our federal system is the opportunity that allows 50 innovative social-policy laboratories to experiment with new and untried solutions, to emulate and improve on other states' approaches, and to evaluate the results. The only productive approach [to tort reform] is to allow state-by-state struggle to continue—at least until a consensus develops on the appropriate response to the issue.[10]

Status of Reform Efforts

Advocates of product liability reform at the federal level have been engaged in a decade-long campaign to have Congress establish uniform rules for product liability litigation. In the House this effort has been centered on the House Energy and Commerce Committee's Sub-Committee on Commerce, Consumer Protection and Competitiveness. The revised version of the current bill, HR-1115, is the result of years of effort by advocates of product liability reform, consumer groups opposed to previous reform legislation, the plaintiff's bar, and others in hammering out a compromise solution.

In essence, the new bill retains the standards of strict liability, as contained in section 402A of the Restatement of Torts (Second). Thus, even when they use substantial care in marketing products they believe to be free of defects, manufacturers can be held liable if a product is sold in a defective condition. The new federal law would set no limits for economic damages or pain and suffering, but would not preempt state laws with respect to punitive damages. Manufacturers meeting government product standards would not be protected from liability.

The bill would, in effect, provide a preemptive federal standard of liability for products, based closely on the State of New Jersey's strict liability statute. Manufacturers would not be held liable for injuries if they could not have known of a defective or unreasonably dangerous aspect of the product at the time of marketing and manufacturing.

The bill emphasizes product warnings and instructions. A product would be considered defective if at the time of manufacture and distribution it did not contain adequate warnings to the consumer of dangers that were already known to the manufacturer, or could be known by experts working with available data. Further, when aware of hazardous aspects of the product (instances in which ordinary use would be dangerous), the manufacturer would have an affirmative duty to warn holders of the product. If such a warning did not occur prior to a claimant's injury, the manufacturer would be held liable.

The Prospects for Reform

The House bill must be approved by the Senate, which will have its own reservations and modifications. As of March, 1988, most observers believe that Congress will not pass such a bill this term. However, much of the groundwork has been worked out and the chances for legislation being enacted by the next Congress are much higher.

Action at the state level is moving far more quickly. The Alliance of American Insurers reports that during the 1987 legislative year there were over 14,300 insurance-related bills introduced in the 50 state legislatures—many of which, of course, are not tort reform bills. Forty-eight states considered product liability tort reform legislation and 24 states will carry these proposals forward into the 1988 sessions. The Alliance reports that 27 states enacted changes in their liability systems and that a number of states are considering changes in the 1988 legislative year.

The majority of all proposed legislative changes at the state level are never enacted. And efforts at general tort as well as

[9] *Business Insurance*, August 17, 1987, p. 8.

[10] Letter by James W. Lytle, of the firm Whiteman, Osterman and Hannah, Albany, N.Y., *New England Journal of Medicine*, Vol. 316, No. 21, p. 1349.

product liability reform have suffered this fate. Looking at specific areas of tort reform, thus far in the past two years:

- Fourteen states passed measures narrowing joint and several liability, with Arizona and New Mexico abolishing the concept entirely. Overall, 35 of the 50 states have acted in some way to limit the "deep-pocket" theory that permitted recovery under joint and several liability.
- Attempts to modify the collateral source rule were also less successful. Thirty-four states considered such reforms and six passed them.
- In the area of punitive damages, 13 states enacted laws changing the amounts that could be awarded or defining the criteria for required proof.
- Attempts to limit amounts paid on pain and suffering damages did not fare well. Thirty-four states considered such measures but only five states passed limits.
- In a number of states, legislatures attempted to stem the tide of "frivolous suits" by passing measures to punish attorneys in such instances. The legislatures recognize that both plaintiff and defense attorneys can engage in dilatory tactics, and five states now allow state judges to impose fees and sanctions on a party bringing or relying on a frivolous action.

Table 33: Desired Tort Liability Reforms in Order of Significance to Firms

Ranking	*Description of Reform*
1	Replacement of strict liability with a fault-based system
2	Curtailment or elimination of joint and several liability
3	Caps on pain and suffering damages
4	Caps on punitive damages
5	Limitations on attorneys' contingency fees
6	Limitations on the time span during which a suit may be filed
7	Allowing use of state-of-the-art defenses
8	Inclusion of collateral source payments in calculating awards payments
9	Federal preemption of state tort liability laws
10	Application of antitrust laws to the insurance industry

Based on responses from 264 companies.

Table 34: CEOs' Views of Tort Liability Reforms Most Likely to Occur

Rank Order	*Description of Reform*
1	Caps on punitive damages
2	Inclusion of collateral source payments in calculating awards payments
3	Caps on pain and suffering damages
4	Curtailment or elimination of joint and several liability
5	Limitations on the time span during which a suit may be filed
6	Allowing use of state-of-the-art defenses
7	Replacement of strict liability with a fault-based system
8	Federal preemption of state tort liability laws
9	Limitations on attorneys' contingency fees
10	Application of antitrust laws to the insurance industry

Based on responses from 264 companies.

Chapter 5
The Experience of Small Companies

In order to assess the impact of the product liability system among small manufacturers, specifically those with fewer than 500 employees, in the fall of 1987 the Board surveyed 2,000 manufacturing firms throughout the United States. These firms were randomly selected from a list of 7,000 such firms provided by the National Association of Manufacturers and were members of that organization. In total, 280 usable responses were obtained. Tables 35 through 66 provide a detailed view of how small companies responded to the Board's survey.

Nearly half of these firms have annual sales of less than $5 million. Three-quarters are producers of industrial machinery and supplies, approximately the nationwide ratio for small manufacturers in the United States (see Tables 35-37).

Assessing the Overall Impact

The CEOs of these smaller firms are more likely to report a major impact from the product liability system than are executives from larger firms. While 42 percent of all the large firms reported a major impact, 59 percent of the CEOs from small companies say that the liability system has had a major impact on their companies. And two-thirds of the small companies with more than $10 million in sales report a major impact.

As is the case with their larger counterparts, small companies producing industrial equipment or consumer durables are more likely to be adversely affected than are firms making consumer nondurables or industrial supplies and raw materials.

And more small-company leaders believe that product liability is having a major impact on their overall industry. Two-thirds of them hold that view, as compared with 45 percent of the larger company CEOs. Seven out of ten small-company CEOs believe that as a result of the liability system their firms and industries have been placed at a competitive disadvantage with foreign producers. About half of the large-company CEOs agree with that conclusion.

Factors Affecting Small Company Operations

This assessment of the impact of product liability on small firms reflects many factors. To begin with, it appears that smaller firms have borne a larger cost burden as a result of the system. About 60 percent of the small firms report a major impact on their direct costs (Table 46), whereas only 42 percent of the larger companies report such an effect. And more small than large firms cite significant general and administrative costs incurred as a result of product liability (see Table 48).

One-quarter to one-half of the small firms (depending on their sales size) have had direct-cost increments of more than 20 percent during the past three years. Again, the sectors most likely to be hit hard are consumer durables and industrial machinery. Because of competitive pressures, four out of ten small companies have had to absorb the increases in direct and administrative costs, thus reducing net profit margins.

While this study did not collect specific data on insurance premiums paid by small companies, the commentary in open-ended questions indicates that insurance costs are a major element in the greater cost burden that many small companies face. A number of the CEOs report premium increases during the past three years ranging from 100 percent to more than 1,000 percent. Only a few firms (3 percent) have been able to join with other small manufacturers to form captive insurers. While many small firms reportedly go uninsured, the survey data show that the number of small and large producers going without insurance is approximately the same—one in seven. However, the larger firms, with greater financial resources, are better equipped to be self-insured and to absorb uninsured product liability losses.

Another study confirms this impression. The Small Business Administration (SBA) recently commissioned a study of several thousand small business entities and measured their liability claims for amounts in excess of $1,000 between the years 1981 and 1986. The chief counsel for the Office of Advocacy of the SBA, testifying before the House Small Business Committee, said small businesses were much less likely than large firms to have liability suits filed against their insurance firms.[1] But he did acknowledge that the smaller firms have been hit harder by insurance shortages.

[1] Testimony of Frank Swain, Chief Counsel for the Office of Advocacy, The U.S. Small Business Administration, before the House Small Business Committee, April 21, 1987.

In essence, from the SBA study as well as from survey and interview data obtained by The Conference Board, it appears that small business firms are less likely to be sued by injured plaintiffs. But they are as likely—or perhaps more likely—to have difficulty getting liability insurance or paying for what they can obtain. Thus, as noted previously, it is possible that small businesses may be disproportionately affected by run-ups in insurance premium costs, increments which occur out of proportion to these firms' actual claims experience. This is certainly the perception of many of the chief executives of small business firms studied by the Board.

Effects on Operations

Small firms are less likely than their larger counterparts to shut down plants or operations—perhaps because they have fewer of them and thus fewer options—or to lay off workers. But they are also likely to decide against introducing a new product line or to choose to discontinue product research because of fears of liability exposure (see Tables 59 and 60).

Because of their size, the smaller companies are less likely to be able to move production offshore. They have fewer resources and opportunities to pursue mergers and acquisitions and are thus less affected than large firms in these areas. Small companies are also less likely than large ones to have instituted changes in product design, to have improved the safety of their products, or to have altered their product-use instructions and warnings. Twice as many large firms report having made safety improvements. Half of the large companies have revamped product-use instructions, whereas less than a third of the smaller companies have made such changes.

There are a variety of reasons for such differences. Smaller firms have less in the way of staff resources to make such changes, may be less able to retool to make safety-related product changes, and may generally have less sophisticated product instruction and warning capabilities.

Small Company Views on Tort Reform

Small-company CEOs disagree with their counterparts in larger firms when it comes to ranking the desirability of various tort reforms. While they too would like to see tort reform, they stress substantially different types of reform and cite different rationales. For example, leading the list of practices that the CEOs of small companies would like to see altered is the contingency fee system by which plaintiffs' lawyers are compensated. Many of these company officials believe that plaintiffs' attorneys are primarily responsible for growth in the tort liability system. Larger-company executive officers, as shown in Chapter 4, rank such a reform as fifth in importance. However, small and large firms agree on the need for a fault-based rather than a strict liability system and on the desirability of comparative damages over joint and several liability. In general, larger-company executives are more inclined to place importance on revisions in punitive damage statutes than are officials from smaller companies.

Looking Ahead

The chief executives of small firms are slightly more pessimistic than large-company CEOs about the future effect of product liability. Three-quarters of the smaller firms expect the impact of the liability system to grow in importance during the next five years. And an equal number anticipate that product liability woes will be an even larger barrier to international competitiveness than they now are. A slightly smaller number of executives from larger firms agree with this assessment.

Table 35: Annual Sales of Small Firms Responding

Annual Sales $	*Percent Distribution*
Less than $1 million	6
$1-4.9 million	40
$5-7.4 million	13
$7.5-10 million	9
More than $10 million	32
	100%

Based on responses from 253 companies.

Table 36: Employment Size of Small Firms Responding

Number of Employees	*Percent Distribution*
Less than 25	19
25-49	26
50-99	19
100-249	19
250-500	13
More than 500	4
	100%

Based on responses from 262 companies.

Table 37:
Principal Product Lines of Small Firms Responding

Product Categories	*Percent Distribution*
Consumer Durables	3
Consumer Nondurables	23
Industrial Equipment & Machinery	21
Industrial Supplies & Materials	53
	100%

Based on responses from 260 companies.

Table 38: Impact of Product Liability on Small Firms

Degree of Impact Reported	*Percent Distribution*
Major	59
Moderate	31
Minimal	10
	100%

Based on responses from 272 companies.

Table 39:
Impact on Product Liability of Small Firms by Size of Firm (annual sales)

	Percent Distribution				
Degree of Impact	Less than $1 mil.	$1-4.9 mil.	$5-7.4 mil.	$7.5-10 mil.	More than $10 mil.
Major	57%	56%	52%	59%	65
Moderate	36	30	35	32	29
Minimal	7	14	13	9	6
	100%	100%	100%	100%	100%

Based on responses from 247 companies.

Table 40: Impact of Product Liability on Individual Small Firms by Product Type

	Percent Distribution			
Degree of Impact Reported	*Consumer Durables*	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Major	75%	54%	69%	54%
Moderate	25	37	24	33
Minimal	–	9	7	13
	100%	100%	100%	100%

Based on responses from 243 companies.

Table 41: Impact of Product Liability on Small Firms' Industries

Degree of Impact Reported	*Percent Distribution*
Major	66
Moderate	27
Minimal	7
	100%

Based on responses from 267 companies.

Table 42: Impact of Product Liability on Small Firms' Industries by Size of Firm (annual sales)

	Percent Distribution				
Degree of Impact Reported	Less than $1 mil.	$1-4.9 mil.	$5-7.4 mil.	$7.5-10 mil.	More than $10 mil.
Major	57%	65%	58%	71%	68%
Moderate	36	27	29	24	25
Minimal	7	8	13	5	7
	100%	100%	100%	100%	100%

Based on responses from 243 companies.

Table 43: Impact of Product Liability on Small Firms by Product Type

	Percent Distribution			
Degree of Impact Reported	*Consumer Durables*	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Major	100%	54%	67%	60%
Moderate	–	21	27	32
Minimal	–	9	6	8
	100%	100%	100%	100%

Based on responses from 250 companies.

Table 44: Impact of Product Liability on Small Firms' International Competitiveness

Degree of Impact Expected	*Percent Distribution*
Major	68
Moderate	25
Minimal	7
	100%

Based on responses from 261 companies.

Table 45: Impact of Product Liability on Small Firms Competitiveness by Product Type

	Percent Distribution			
Degree of Impact Reported	*Consumer Durables*	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Major	100%	70%	68%	66%
Moderate	–	20	25	27
Minimal	–	10	7	7
	100%	100%	100%	100%

Based on responses from 243 companies.

Table 46: Impact of Product Liability on Small Firms' Direct Costs

Degree of Impact Reported	*Percent Distribution*
Major	61
Moderate	28
Minor	11
	100%

Based on responses from 272 companies.

Table 47: Impact of Product Liability on Small Firms' Direct Costs by Product Type

	Percent Distribution			
Degree of Impact Reported	*Consumer Durables*	*Consumer Nondurables*	*Industrial Equipment & Machinery*	*Industrial Materials & Supplies*
Major	87%	62%	67%	55%
Moderate	13	32	28	28
Minimal	–	6	5	17
	100%	100%	100%	100%

Based on responses from 254 companies.

Table 48: Impact of Product Liability on Small Firms' General/Administrative Costs

Degree of Impact Reported	*Percent Distribution*
Major	44
Moderate	37
Minor	19
	100%

Based on responses from 270 companies.

Table 49:
Impact of Product Liability on Small Firms' General/Administrative Costs

Degree of Impact Reported	*Percent Distribution*				
	Less than $1 mil.	$1-4.9 mil.	$5-7.4 mil.	$7.5-10 mil.	More than $10 mil.
Major	43%	39%	32%	52%	54%
Moderate	21	39	52	33	30
Minimal	36	22	16	15	16
	100%	100%	100%	100%	100%

Based on responses from 195 companies.

Table 50:
Impact of Product Liability on Small Firms' Costs of Foregone Opportunities

Degree of Impact Reported	*Percent Distribution*
Major	43
Moderate	33
Minimal	24
	100%

Based on responses from 262 companies.

Table 51:
Average Increase in Small Firms' Direct Costs 1984-1987

Percent of Increase	*Percent Distribution*
Less than 1%	2
1-2%	10
3-5%	24
6-10%	19
11-20%	12
More than 20%	33
	100%

Based on responses from 136 companies.

Table 52:
Average Increase in Small Firms' Administrative Costs 1984-1987

Percent of Increase	*Percent Distribution*
Less than 1%	2
1-2%	18
3-5%	24
6-10%	18
11-20%	21
More than 20%	17
	100%

Based on responses from 137 companies.

Table 53:
Median Increase in Small Firms' Direct Costs 1984-1987 by Size of Firm (annual sales)

	Percent Distribution				
Percent increase	Less than $1 mil.	$1-4.9 mil.	$5-7.4 mil.	$7.5-10 mil.	More than $10 mil.
Less than 1%	–	8%	–	–	5%
1-2%	13	4	7	10	15
3-5%	36	21	13	20	18
6-10%	13	19	20	30	22
11-20%	13	24	13	10	3
More than 20%	25	24	47	30	37
	100%	100%	100%	100%	100%

Based on responses from 126 companies.

Table 54:
Median Increase in Small Firms' General/Administrative Costs 1984-1987, by Size of Firm (annual sales)

	Percent Distribution				
Percent Increase	Less than $1 mil.	$1-4.9 mil.	$5-7.4 mil.	$7.5-10 mil.	More than $10 mil.
Less than 1%	–	5%	–	9%	2%
1-2%	–	12	33	9	12
3-5%	33	25	–	18	24
6-10%	33	21	8	37	15
11-20%	33	21	33	18	27
More than 20%	–	16	25	9	20
	100%	100%	100%	100%	100%

Based on responses from 110 companies.

Table 55:
Average Increase in Small Firms' Direct Costs 1984-1987 by Product Type

Degree of Increase Reported	Percent Distribution			
	Consumer Durables	Consumer Nondurables	Industrial Equipment & Machinery	Industrial Materials & Supplies
Less than 1%	–	3%	–	3%
1-2%	25	3	9	13
3-5%	50	31	22	21
6-10%	–	24	13	19
11-20%	25	10	19	9
More than 20%	–	28	37	35
	100%	100%	100%	100%

Based on responses from 128 companies.

Table 56:
Median Increase in Small Firms' General/Administrative Costs 1984-1987 by Product Type

Degree of Increase Reported	Percent Distribution			
	Consumer Durables	Consumer Nondurables	Industrial Equipment & Machinery	Industrial Materials & Supplies
Less than 1%	–	8%	4%	4%
1-2%	20	12	14	13
3-5%	40	32	4	21
6-10%	20	24	14	21
11-20%	20	16	23	28
More than 20%	–	8	41	13
	100%	100%	100%	100%

Based on responses from 113 companies.

Table 57: Pricing Strategies Used by Small Firms to Deal with Product Liability Costs

Strategy Employed	Percent Distribution
Absorbed costs	40
Raised product prices	17
Absorbed costs & raised prices	25
Did nothing	18
	100%

Based on responses from 279 companies.

Table 58: Small Firms' Alternative Insurance Strategy Options

Strategy Option	Percent Distribution
No change in insurer	82
Form captive insurer	3
Operate without insurance	15
	100%

Based on responses from 279 companies.

Table 59:
Adverse Impacts Cited by Small Firms Based on *Actual* Liability Experience

Type of Impact	Percent of Firms Reporting Impact
Closed production plants	2
Laid off workers	9
Discontinued product lines	27
Decided against introducing new products	31
Decided against acquiring/merging	11
Discontinued product research	18
Moved production offshore	2
Lost market share	25

Based on responses from 279 companies.

Table 60:
Adverse Impacts Cited by Small Firms Based on *Anticipated* Liability Experience

Type of Impact	Percent of Firms Reporting Impact
Closed production plants	2
Laid off workers	2
Discontinued product lines	2
Decided against introducing new products	15
Decided against acquiring/merging	5
Discontinued product research	7
Moved production offshore	1

Based on responses from 279 companies.

Table 61: Beneficial Impacts Cited by Small Firms Based on *Actual* Liability Experience

Type of Impact	*Percent of Firms Reporting Impact*
Improved safety of products	17
Redesigned product lines	24
Improved product usage and warnings	29

Based on responses from 279 companies.

Table 62: Beneficial Impacts Cited by Small Firms Based on *Anticipated* Liability Experience

Type of Impact	*Percent of Firms Reporting Impact*
Improved safety of products	10
Redesigned product lines	12
Improved product usage and warnings	13

Based on responses from 279 companies.

Table 63: Expectations of Future Impact of Liability System on Small Firms

Impact on Firm	*Percent Distribution*
Will grow in significance	75
Will remain the same	18
Will decrease in significance	7
	100%

Based on responses from 268 companies.

Table 64: Small Company Expectations of Future Impact of Liability System on U.S. Competitiveness

Impact on U.S. Competitiveness	*Percent Distribution*
Will grow in significance	76
Will remain the same	9
Will decrease in significance	15
	100%

Based on responses from 256 companies.

Table 65: Rank Order of Tort Liability Reforms by Significance to Small Firms

Ranking	*Description of Reform*
1	Limitations on attorneys contingency fees
2	Curtailment or elimination of joint and several liability
3	Replacement of strict liability with a fault-based system
4	Allowing use of state-of-the-art defenses
5	Caps on pain and suffering damages
6	Federal preemption of state tort liability laws
7	Limitations on the time span during which a suit may be filed
8	Caps on punitive damages
9	Inclusion of collateral source payments in calculating awards payments
10	Application of anti-trust laws to the insurance industry

Based on responses from 279 companies

Table 66: Small Company CEOs' Views of Tort Liability Reforms Most Likely to Occur

Rank Order	*Description of Reform*
1	Federal preemption of state tort liability laws
2	Curtailment or elimination of joint and several liability
3	Limitations on the time span during which a suit may be filed
4	Replacement of strict liability with a fault-based system
5	Caps on pain and suffering damages
6	Inclusion of collateral source payments in calculating awards payments
7	Limitations on attorneys' contingency fees
8	Caps on punitive damages
9	Allowing use of state-of-the-art defenses
10	Application of anti-trust laws to the insurance industry

Based on responses from 279 companies.